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IN THE

Supreme Court of the United States

October Term 1963

No. 830

Civil.

STEVENS BROS. FOUNDATION, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

JOHN M. SULLIVAN
Attorney for Petitioner
W2200 First National Bank Building
St. Paul, Minnesota 55101

Of Counsel:
BRIGGS AND MORGAN
W2200 First National Bank Building
St. Paul, Minnesota 55101

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Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Eighth Circuit entered in the above case on November 15, 1963.

Opinions Below

The opinion of the Tax Court of the United States is reported at 39 T.C. 93 (39 T.C. No. 11). The opinion of the Court of Appeals for the Third Circuit is reported at 324 F. 2d 623.

Jurisdiction

The judgment of the Court of Appeals for the Eighth Circuit was made and entered on November 15, 1963 and a copy thereof is appended to this petition in the Appendix at page 102. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

Questions Presented

Stevens Bros. Foundation, Inc., (Foundation) was incorporated under the laws of Delaware on December 31, 1942 as a non-profit, non-stock membership corporation. In 1943 Foundation applied for exemption from Federal income taxes as a charitable corporation. By letter of May 1, 1947, the Commissioner of Internal Revenue granted the Foundation exempt status subject to the condition that the Foundation should not subsequently change its character or purpose or its method of operation. By letter dated August 24, 1954 the Commissioner notified the Foundation that its exemption was revoked, and subsequently on September 8, 1954 the District Director of Internal Revenue notified Foundation that it was liable for federal corporation income tax returns and enclosed forms for the years 1948 to 1953, inclusive. After audit, conferences and negotiations, the Commissioner notified Foundation of specific deficiencies by letter June 14, 1960 for the fiscal years March 31, 1948 to March 31, 1958, inclusive.[1] The Tax Court sustained the assertion of deficiencies in corporate income and personal holding company taxes and penalties.[2] The Court of Appeals affirmed except with respect to personal holding company tax and remanded one in-

[1] Footnotes are listed immediately preceding Appendix.

substantial issue to the Tax Court for further consideration.[3]
The questions presented are:

(1) Whether the Foundation was operated exclusively for charitable purposes during its taxable years 1948 through 1955 and was exempt from taxation during such years.

(2) Whether the Foundation unreasonably accumulated income during its taxable years 1952 through 1958 and was exempt from taxation during its taxable years 1952 through 1958.

(3) Whether the Commissioner abused his discretion in retroactively revoking the 1947 ruling exempting Foundation from taxation as a charitable organization.

(4) Whether Foundation was subject to additions to tax for failures to file corporation income tax returns for its taxable years 1948 through 1954.

Statutes, Federal, Rules and Regulations, Involved

The pertinent portions of the Internal Revenue Code 26 U.S.C., the Revenue Act of 1950, Internal Revenue Regulations, Rulings of the Internal Revenue Service are set forth in the Appendix at page 104-119.

Statement

The Foundation was incorporated by Edward Fenton Stevens (Stevens), his wife, and two of his brothers under the general corporation of laws of Delaware on December 31, 1942. Six other persons—related to Stevens either by blood or marriage—were subsequently admitted to membership in Foundation. It maintains its principal office in St. Paul, Minnesota.[4]

In 1943, the Foundation applied for exemption from federal income taxes as a corporation operated exclusively for religious, charitable, scientific, literary or educational purposes. By letter of May 1, 1947, the Foundation was granted exempt status by the Commissioner, subject to the qualification that it not change its character or purpose or its method of operation.[5]

The four founders of Foundation were also partners in Stevens Bros. Contractors (Partnership), and shared equally in Partnership's profits until the death of one partner in 1955; thereafter, the remaining three persons shared equally. During the years here involved, Partnership owned two-thirds of the stock of a construction company known as Stevens Bros. & Miller-Hutchinson Company, Inc. (Corporation). Stevens was president of Corporation and R. C. Hutchinson—who had no interest in Foundation or Partnership—was its secretary-treasurer.[6]

In 1947, Hutchinson, who was then in active charge of Corporation, consulted with Stevens about bidding on a contract to build the floor at the Algiers Locks in Louisiana. The Government required a bid bond, and the surety company had informed Hutchinson that it would not issue a bond on Corporation's bid unless an additional $50,000 in cash was absolutely subordinated to the contract. The Corporation's funds were at that time committed to the completion of other jobs, and the bank with which Corporation normally did its business refused to lend it additional money. On May 29, 1947, at the request of Hutchinson, Foundation's board of directors agreed to advance $50,000 to Corporation in return for one-third of the profits from the job, plus repayment of the advance.

Shortly thereafter, Hutchinson advised Foundation that the surety company now insisted on having $75,000 subordinated to the contract instead of the previous $50,000 requirement. On July 1, 1947, the earlier agreement was cancelled, and Foundation agreed to advance the larger amount to Corporation in return for one-half of the profits from the contract, plus repayment of the advance. Corporation's bid was accepted, and Foundation advanced the $75,000. In 1948, Foundation advanced an additional $40,000 to Corporation to pay for certain material required before further work could be done on the project. No additional consideration was received by Foundation for this $40,000, and the sum was ultimately returned.[8]

Before the Algiers Lock floor contract was completed, Corporation bid on the contract for erection of the walls at the same lock, received the award, and unsuccessfully attempted to secure a bond for the contract bid without being required to furnish additional funds. After Corporation's bank once again would not advance the funds, the agreement between Foundation and Corporation covering the floor contract was extended to the wall contract, and the $75,000 previously advanced was left with Corporation.[9]

Before the wall contract was completed, Corporation was invited by T. L. James & Company, Inc. (James) to bid on the contract for the Cheatham Lock project in Tennessee. James and Corporation were awarded the contract and agreed to divide the profits from the project equally. Since Foundation then extended the financial terms of the Algiers Lock project agreement to cover the Cheatham Lock project, half of Corporation's share of the profits under the Cheatham contract was to go to Foundation. In addition to the $75,000 covered by the extended agreement, Foundation also ad-

vanced $25,000 on August 20, 1951, and $50,000 on October 4, 1951 for use on the Cheatham Lock project. The $75,000 original advance and the $75,000 additional investment in the Cheatham Lock project in 1951 were returned to Foundation about 1953, and its construction project relationship with Corporation was terminated in 1954.[10]

Foundation received $173,387.55 in income for its involvement in the construction projects. No part of the income so derived was diverted to its members.[11]

About 1952, Foundation began making educational loans to college students. Repayment was waived in the case of most or all of the 32 loans, totaling $4,605, made during Foundation's taxable years 1953 through 1955. For its taxable years, 1956 through 1958, Foundation made 36 loans totaling $7,496, which are extended without question when a student advances a good reason for delay in payment.[12]

Foundation's books for its taxable years 1948 through 1958 indicate: receipts $745,033.60 of which $61,283.45 were gifts and $683,750.15 was income from investments; expenses, $120,053.70; contributions and grants disbursed $23,294.39; student loans, $7,496; and a surplus balance of $601,685.51 of which $443,372.34 was found by the Tax Court to be attributable to income (other than capital gains) less expenses and contributions.[13]

In order to provide the Foundation with initial capital funds for investment Partnership loaned certain sums of money to Foundation from February, 1946, to October, 1953. The total outstanding on the first day of any month during that period ranged from $496,973.71 to $969,211.62, and averaged $790,802.91 for that period. Foundation paid no interest on these loans through 1948, and thereafter until 1954 paid various rates of interest, the rate of which over

the whole period averaged approximately one and two-thirds percent. Since 1954 Foundation has not borrowed funds from Partnership or from any other source and has not paid any interest to Partnership.[14]

At the time of the trial in the Tax Court, Foundation's investments had an approximate value of $950,000.[15]

On or before August 20, 1953, Foundation's members determined a plan to accumulate $1,000,000 in Foundation, from which they calculated an annual income of $50,000 could be derived. They deemed this income sufficient annually to meet expenses and to provide expenditures for Foundation's charitable purposes.[15a]

By letter dated August 24, 1954, Commissioner notified the Foundation that its tax exempt status was revoked. By letter dated September 8, 1954, the District Director at St. Paul notified the Foundation that it was liable for federal corporation income tax returns and enclosed forms for the years 1948 to 1953, inclusive. After audit, various conferences and other negotiations, Commissioner notified the Foundation of specific deficiencies by letter of June 14, 1960.[16]

Petitioner filed information returns (Form 990 and 990-A), paying no tax therewith, for the fiscal years 1948 through 1954, inclusive, with the Collector of Internal Revenue, Saint Paul, Minnesota, and corporate returns (Form 1120) paying taxes aggregating $5,913.61 therewith, for the fiscal years 1955 through 1958, inclusive, with the District Director of Internal Revenue for the District of Minnesota. Claims for refund (Form 843) for the taxes paid for the fiscal years 1955 through 1958 were filed concurrently with the returns for such years.[17]

By Notice dated June 14, 1960, the Commissioner determined income tax deficiencies of $148,252.71, personal hold-

ing company tax deficiencies of $167,322.39 and penalties of $78,893.82 later reduced by stipulation by $20,815.39.[18]

The asserted deficiencies and penalties were based on determinations that: Foundation did not qualify as an organization exempt from taxation under Section 101(6) of the Internal Revenue Code of 1939 and Section 501(3) [sic] of the Internal Revenue Code of 1954; Foundation was a personal holding company as defined in Section 501(a) of the 1939 Code, and Section 542(a) of the 1954 Code; and that Foundation was subject to additions to the tax under Sections 291(a) and 508 of the 1939 Code and Section 6651(a) of the 1954 Code for failure to file income tax returns for the fiscal years 1948 through 1954, and for failure to file personal holding company tax returns for the fiscal years 1948, 1952 through 1958, inclusive.[19]

In support of such determinations, the Commissioner asserted that investments made by the Foundation evidenced Foundation had not been organized or operated exclusively for charitable purposes; that from such investment the founders of the Foundation profited; and apart from such allegations, Foundation had unreasonably accumulated income for its charitable purposes. In addition, the Commissioner contended the Foundation was subject to the personal holding company tax. The Commissioner also contended: Foundation received ordinary income in the amount of $25,778.24 in the taxable year ended March 31, 1955 and did not have for that year, a long term capital gain of $48,306.44 and an ordinary loss of $22,528.20; Foundation did not incur a capital loss from the worthlessness of Denver and Rio Grande Railway stock for the taxable year ended March 31, 1949 in the amount of $9,849.40.[20]

Proceedings in the Tax Court, under sections 6213(a) and 7442 of the Internal Revenue Code, were initiated by petition filed September 14, 1960. Hearing was held on May 16, and 17, 1961. By opinion dated October 16, 1962, the Tax Court in essence held:

(a) Foundation had not been operated exclusively for charitable purposes for the years 1948 through 1955;

(b) It had unreasonably accumulated income during the years 1952 through 1958, and

(c) It was a personal holding company for the fiscal years 1952 through 1954, and 1956 through 1958.[21]

The Tax Court also held the Foundation was subject to additions to the tax for failure to file corporation income tax returns and for failure to file personal holding company tax returns. Additional findings were made with respect to the effect of statutes of limitations on assessments made by the Commissioner, as to the deductibility of certain security losses and the character of certain income as capital gains for the years ending March 31, 1948 and March 31, 1955, respectively.[22]

On review, under the authority of sections 7482(a) and and 7483 the Court of Appeals affirmed the findings of the Tax Court except that it held that the Foundation was not subject to the personal holding company tax[23] and remanded to the Tax Court the question as to whether certain equipment used in the trade or business was depreciable and its sale was subject to capital gains treatment.[24] By its opinion the Court of Appeals held in essence:

(1) The Foundation investment in construction contracts with Corporation showed that the Foundation was not operated exclusively for charitable purposes;[25]

(2) The Foundation did not have a concrete or definite charitable program, with a functional objective, which required an accumulation of a large percentage of its income, and it therefore unreasonably accumulated income;[26]

(3) The Foundation did not report to the Commissioner changes in its activities as related to its investments with the Corporation and therefore the retroactive revocation of tax exemption by the Commissioner was not an abuse of his discretion.[27]

(4) Additions to the tax for failure to file returns for the taxable years 1948-1954 was proper in light of the retroactive tax exemption.[28]

Reasons for Granting the Writ

1. The decision below should be reviewed because it erroneously constricts the application of the pertinent exemption provisions of the Internal Revenue Code. (Sections 501(a) and 501(c)(3) of the 1954 Internal Revenue Code and Section 101(6) of the 1939 Code.[29]) It misconstrues the decision of this Court in *Better Business Bureau of Washington, D. C. v. United States*, 326 U.S. 279, and in so doing restricts an exempt organization from engaging in any activity that is not religious, charitable, scientific, literary or educational even though the activity serves religious, charitable, scientific, literary or educational purposes.

The issue in Better Business Bureau case was whether wages of employees of such an organization were subject to social security taxes under the statutory provision which excepted service in the employ of a "corporation, community chest, fund or foundation organized and operated exclusively for religious, charitable, scientific, literary or educational purposes."

This Court stated that "exclusively" means that the presence of a single non-qualified purpose, if substantial in nature will destroy exemption regardless of the number or importance of truly qualified purposes. The Court examined the Bureau's promotion of an ethical and profitable business community in pursuit of its corporate purposes for the promotion of "mutual welfare, protection and improvement of business methods among merchants" and the securing of "educational and scientific advancements of business methods" for the successful and profitable operation of business, and found the educational aspects of the petitioner were incidental to its purposes.

In an earlier case, *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924) this Court considered whether the use of petitioner's properties to produce income and trades in wine, chocolate and other articles so violated the operation "exclusively for religious, charitable, and educational purposes" as to cause Sagrada to lose its tax exempt character. This Court drew a distinction between "activity" and "purpose" which the Court below in the instant matter has erroneously failed to follow.

This distinction between activity and purpose was carefully preserved in *Samuel Friedland Foundation*, 144 F. Supp. 74, where the Court noted that "the investment of funds of a charitable organization in securities has never been conceived of as a "purpose" of the organization. It has always been treated as an incidental activity subsequent to the fundamental charitable objects", citing the *Trinidad* case.

The same distinction is maintained by the Regulations of the Commissioner wherein it is stated that an organization may meet requirements of being operated exclusively for charitable purposes "although it operates a trade or busi

ness as a substantial part of its activities if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513" (Reg. Secs. 1.501(c)(3)-(c)1 and 1.501-c(3)-1(e)(1)).[30] It is obvious that such a regulation encompasses more than mere investment and that its scope looks to the question of whether an activity was the purpose for operation or whether it merely served the exempt charitable purposes.

The distinction between activity and purpose is preserved in the whole statutory pattern. Congress has provided: (a) if an otherwise exempt organization engages in certain "prohibited transactions" (Section 503(c)),[31] it will be denied exemption for taxable years after the taxable year during which it is notified by the Commissioner that it has engaged in any such transactions; and (b) with respect to certain other activities or transactions it may be taxed on income derived therefrom as unrelated business taxable income but without losing its exemption (Sections 501(b), 511(a), 512(a) and 513(a)).[32]

The Court below obliterated the distinction drawn by this Court, by the statutes, and the regulations, between activity and purpose and then ascribed "purpose" to one of the Foundation's investments and disregarded its character as an activity. It did so by affirming the assertion of the Commissioner and the Tax Court that an investment from which responsible officials of the Foundation might be held to have received an indirect benefit becomes a purpose and is not an activity.[33]

This failure of the Commissioner, Tax Court and Court of Appeals to preserve the distinction between activity and pur-

pose requires this Court to reaffirm the distinction. Failure so to do will force exempt organizations to invest at the peril the Commissioner may second guess the propriety of the organizations' investment judgment. The Commissioner consequently will hereafter become a silent party to every investment decision for charitable organizations without power to vote or recommend but with plenary power to dissent or veto.

2. The decision should be reviewed because it creates uncertainty on the question of the legitimate extent of accumulations by exempt organizations, misconstrues the statutory provisions with respect thereto, and encourages arbitrary denial of exemption whenever the Commissioner in his unrestricted whim decrees what amount of funds are required to accomplish a particular objective of an exempt organization.[34]

If this Court grants this petition, a presentation of the merits will permit a demonstration of the substantial lack of uniformity in the Commissioner's rulings in accumulation cases and an utter absence of any statement of objective standards by which accumulations can be measured or the propriety of his rulings tested. Such an analysis will, it is submitted, present serious questions of unequal treatment of taxpayers similarly situated.

To the many persons throughout the nation currently confronted (most frequently without compensation) with the practical problems of management of charitable corporations and foundations, the decision of the Court of Appeals gives the clear impression that the Commissioner alone is permitted, without restriction, to determine the immense questions of social policy involved in the decision of how many dollars a particular organization requires to accomplish a socially desirable objective.

Specifically, the Commissioner, the Tax Court and the Court of Appeals have agreed that a capital structure of one million dollars is too large for petitioner. It is apparent that any such determination must rest upon *some* assumptions. One such assumption is that income should be sufficient to pay operating expenses. What operating expenses *will* ultimately be will depend upon how large a program of good works the Commissioner permits this particular foundation to embark.

If one assumes minimum annual operating expenses requirements in the amount of $15,000, income from a fund of $300,000 at a 5% yield would be required. In relation to amounts accumulated or to be accumulated, is $300,000 reasonable and $1,000,000 unreasonable? It would hardly seem so, for if all income of a charitable organization were devoted to meeting expenses, how could it properly carry out its charitable purposes? Moreover, it is not likely the Treasury would accord exempt status to an organization because its retained income was modest if all its income were devoted to operating expenses. In such light it might well be argued that its income should be at least twice operating expenses so that at least half could be devoted to charitable purposes. If so, the organization's retained income goal should be $600,000. Is that amount reasonable?

Nothing so far said by anyone in this case offers any clue. Is a fund of $900,000 to yield three times expense requirements reasonable? Obviously, the larger the fund, the greater is the income, and the greater is the proportion of such income available to meet expenses, to make distributions and to accumulate to meet future needs. It is obvious that the more wealthy organizations would be favored over organizations with modest funds, since the former's income

would suffice for operating expenses and distributions without need to accumulate resources to provide against minimum future financial needs. Thus, by the clearest implication the decision permits the Commissioner to say that charities which begin large can grow larger; those which begin small must remain insignificant. In any event, until the Commissioner is required to do more than state that he does not like a particular accumulation his every determination will appear to, and will in fact, be arbitrary.

It is submitted that the decision, if allowed to stand, has the *in terrorem* effect of warning each of the thousands of exempt organizations that each will embark upon a program of expanded public service at the hazard of the displeasure of the Commissioner and thereby the loss of exemption. This Court should examine the decision below with a view to quieting the anxieties which it necessarily produces and stating the proper limits within which the Commissioner wields his power.

3. The decision should be reviewed because it attributes to the decision of this Court in *Automobile Club v. Commissioner*, 353 U.S. 180, an unwarranted view of the scope of retroactive revocation. That decision stated the general proposition that under section 3791(b)[35] of the 1939 Internal Revenue Code the Commissioner could prescribe the extent to which a ruling or regulation could be applied without retroactive effect (see also section 7805(b) of the 1954 Code).[36] It further noted that the issue to be resolved was whether in the circumstances the Commissioner abused his discretion. That case revealed that the Commissioner had issued an exemption letter to the Automobile Club in 1934 and 1938. In 1945 the Commissioner revoked the Club's

exemption, but before doing so, the Commissioner published, in 1943, public notice that he had reconsidered his position reflected in earlier rulings applicable to automobile clubs (GCM 23688, 1943 CB 283).[37] Consequently, from the time publication of that GCM, the Automobile Club was on notice that the exempt status previously granted to it was likely to be withdrawn. When the Commissioner did revoke its exempt status, the revocation was made applicable only to the period after which the GCM was published, that is, 1943, and to subsequent years. This Court held that in such circumstances the Commissioner did not abuse his discretion. Moreover, it cited *Lesavoy Foundation v. Commissioner*, 238 F.2d 589, (3rd Cir., 1956) for the proposition that revocation of an exemption letter relied upon by the taxpayer may constitute an abuse of discretion by the Commissioner.

This same principle is reflected in the Code, for exemption is not denied retroactively where an organization engages in a prohibited transaction or improperly accumulates income, but is applied in the first case only after notification by the Commissioner and in the second case only with respect to each separate year for which improper accumulations are determined. (Sections 503(a)(2) and 504 of the 1954 Code and Sections 3813(c)(2) and 3814 of the 1939 Code; see also Section 3021(b) of the Revenue Act of 1950.)[38]

It is at least arguable that the provisions of those two sections prescribe that those are the only sanctions which the Commissioner shall be permitted to apply in either unreasonable accumulations or prohibited transaction cases. In any event, the alternatives provided by those sections are factors to be carefully weighed in determining the propriety of retroactive revocation. A review of the entire case will reveal that

the Commissioner feels free to disregard any standards, including his own (Rev. Rul. 54-164, Sec. 6, 1954-1, CB 88, 91).[39] The Tax Court adopts his view, and the Court of Appeals refuses to call either to task.

The failure of the Court below to circumscribe the discretion of the Commissioner to retroactively deny exemption to a charitable organization, as this Court did in the Automobile Club case opens the door for the Commissioner arbitrarily to choose whatever retribution he would impose on an organization. This Court should again confine the Commissioner's discretion to avoid indiscriminate abuse of his authority.

4. The decision below should be reviewed because it erroneously affirms the Tax Court's and the Commissioner's incorrect assessment of penalties for failure to file corporate tax returns for the years 1948 to 1954, inclusive.[40] Those are the years to which the Commissioner's retroactive revocation are applicable.

Clearly such returns were not due at the regular time for filing, for the Foundation then had an exempt ruling.

The Commissioner erroneously applied two sections of the 1939 Code. Section 53(a)[41] states when returns are required to be filed: "* * * on or before the fifteenth day of the third month following the close of the fiscal year. * * *" Such time had passed with respect to every year in question, before notice of revocation. The Commissioner, undaunted, wrote his own statute and imposed approximately $15,000 in penalties for its violation.

The Commissioner also misconstrued Section 291(a).[42] That section imposes a penalty for failure to file *within the time prescribed by law* (already noted as being completely inapplicable) unless the failure was for reasonable cause. Reliance upon his exempt ruling, if he is permitted to revoke

retroactively, is no such reasonable cause say the Commissioner, the Tax Court and the Court of Appeals.[43] Assuming, *arguendo*, that such a theory is sustainable upon some basis, the unpardonable vice of the case is that the Tax Court has determined that "reasonable cause" can consist *only* in the advice of competent tax specialists to the effect that no return need be filed. But for a few other decisions of the Tax Court, no one would surmise that when Congress said "reasonable cause" it did not mean just that.

Any decision by the Commissioner based upon so constricted a construction cannot be other than arbitrary, and no assumption (absent here) by the Tax Court or the Court of Appeals that the Commisisoner might have been able to think of other grounds can change the arbitrary nature of the determination.

Nothing in the case can be adduced to support the proposition that failure to file at a later date was in any way, however insignificant, necessary to present the Commissioner with necessary information, *Automobile Club v. Commissioner, supra.*

It is submitted that a review of the entire record will disclose this penalty to be a peremptory forfeiture.

Conclusion

It is recognized that the function of this petition is to present cogent reasons for review without discussion of the merits of the case. It is doubted whether such complete divorcement is possible. In any event, the following general comment upon the treatment of this case by the Tax Court and the Court of Appeals is worthy of this Court's notice at this juncture.

In addition to the specific issues which have been set forth as requiring review, the method of review as evidenced by the two opinions below merits careful examination by this Court.

The Foundation asserted in each forum that specified acts and determinations by the Commissioner were arbitrary, capricious, and unreasonable. Each Court examined each such specification, *seriatim*, and said as to *each* upon which the Commissioner now stands affirmed: This is not so arbitrary, unreasonable or capricious as to require a reversal.

Such an approach, it is submitted, may be appropriate in a single issue case. But the question whether treatment of a taxpayer is arbitrary in a complex case can only be measured by a review which says, in effect: Even though a decision adverse to the taxpayer on any one of a dozen issues would be sustainable, has the Commissioner been arbitrary if he has decided all issues against the taxpayer?

It is respectfully submitted that on a review of the entire case this Court will find from the treatment of the individual issues and from their collective treatment that the Foundation has been dealt with arbitrarily and capriciously.

Based upon the foregoing, it is respectfully submitted that the Court should issue its writ to the Court of Appeals for the Eighth Circuit.

Respectfully submitted,
JOHN M. SULLIVAN
Attorney for Petitioner

FOOTNOTE REFERENCES

References, except where noted, are to pages in the appendix

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APPENDIX

STEVENS BROS. FOUNDATION, INC.,

PETITIONER,

v.

COMMISSIONER OF INTERNAL REVENUE,

RESPONDENT.

Docket No. 89120. Filed October 16, 1962.

1. Under section 302 (b), Revenue Act of 1950, filing of exempt organization information return constitutes filing of a return for statute of limitations purposes only if the organization loses its exemption because it engages in a trade or business for profit.

2. Except where section 302 (b), Revenue Act of 1950, applies, exempt organization information returns are not "returns" for statute of limitations purposes under the 1939 Code.

3. The Commissioner is not estopped from revoking an exemption ruling retroactively to the time of a material change in the relevant facts or applicable law occurring after issuance of that ruling.

4. When one major purpose for an organization's entry into a substantial long-term business transaction is to benefit the organization's founders, then that organization is not operating exclusively for tax-exempt purposes, even though the organization also benefits from that transaction.

5. An accumulation for the purpose of accumulating a certain dollar amount, constitutes an unreasonable accumulation under sections 3814 (a) of the 1939 Code

and 504 (a) (1) of the 1954 Code, where no specific project has been determined for the use of that amount and where the current charitable expenditures of the organization are a small fraction of the "excess accumulations."

6. Accumulations out of income are unreasonable under sections 3814 (1) of the 1939 Code and 504 (a) (1) of the 1954 Code unless for each taxable year both current accumulations and accumulations out of the income of prior years are supported by a currently existing program justifying such accumulations.

7. Memberships in a nonstock corporation are equivalent to stockholdings for personal holding company purposes if they include the right to share in the corporation's profits, either currently (as by distribution or diversion of profits) or ultimately (as on dissolution).

8. Petitioner advanced funds to canal lock construction projects in exchange for repayment of advances plus a share of the profits. *Held:* A joint venture was created, taxable as a partnership. Petitioner's profits retain the same taxable characteristics as they had to the joint venture.

9. Belief of petitioner's president as to the worthlessness of securities held by petitioner, together with slight evidence of unsuccessful efforts to sell the securities, *held*, insufficient to carry the burden of proving worthlessness.

10. Deductibility of interest payments by a cash basis taxpayer is not affected by the payee's members' subsequent promise to repay part of those payments where repayment is not actually effected.

11. A joint venturer's income includes its share of the joint venture's profit for the taxable year of the joint venture ending within the taxable year of joint venturer.

12. Evidence does not establish that certain property used in canal lock construction projects was subject to an allowance for depreciation or that it was held more than 6 months. *Held*, the property is not shown to be "section 1231 assets" and profit on its sale is not treated as being derived from sale or exchange of capital assets.

13. Petitioner's exemption certificate was revoked in 1954 retroactive to its 1948 taxable year. Because of petitioner's failure to show reliance upon the timely advice of competent, informed tax counsel that no returns should be filed after the revocation for the earlier years, *held*, additions to tax for failure to file timely returns are upheld despite petitioner's not unreasonable argument on the issue of tax liability.

John M. Sullivan, Esq., and *Frank J. Hammond Esq.*, for the respondent.

Donald W. Wolf, Esq., for the petitioner.

TRAIN, *Judge:* Respondent determined deficiencies in income and personal holding company taxes and additions to tax of the petitioner as follows:

Fiscal year ended Mar. 31—	Deficiency	Addition to the tax	
		Sec. 291(a) I.R.C. 1939	Sec. 6651(a) I.R.C. 1954
	Income tax		
1948	$21,634.48	$5,408.62	
1949	5,013.28	1,253.32	
1950	28,025.41	7,006.35	
1951	5,258.17	1,314.54	
1952	2,135.97	533.99	
1953	1,623.29	405.82	
1954	1,300.55	325.14	
1955	44,158.44		$11,039.61
1956	8,372.55		2,093.14
1957	15,541.64		3,885.41
1958	15,188.92		3,797.23
	Personal holding company surtax		
1948	$73,308.62	18,327.16	
1952	39,960.04	9,990.01	
1953	30,462.05	7,615.51	
1954	23,591.88	5,897.97	

Respondent has conceded the inapplicability of the additions to tax under section 6651 (a) of the Internal Revenue Code of 1954 for petitioner's taxable years 1955 through 1958.

The issues remaining[1] to be decided are:

(1) Whether respondent is barred by the statute of limitations from asserting deficiencies and additions to tax for each of petitioner's taxable years 1948 through 1954;

(2) Whether respondent is estopped from retroactively revoking in 1954 his 1947 ruling that petitioner was exempt from taxation as a charitable organization;

(3) Whether petitioner was exempt from taxation as a charitable organization under section 101 (6) of the Internal Revenue Code of 1939 during each of its taxable years 1948 through 1954 and under section 501 (c) (3) of the Internal Revenue Code of 1954 during each of its taxable years 1955 through 1958;

(4) Whether petitioner is liable for personal holding company surtax pursuant to section 500 of the Internal Revenue

[1] Other matters raised by the pleadings were neither argued on brief nor listed on brief among the remaining issues. We assume they have been abandoned.

Code of 1939 for each of its taxable years 1948, 1952, 1953 and 1954, and for personal holding company tax pursuant to section 541 of the Internal Revenue Code of 1054 for each of its taxable years 1955 through 1958;

(5) Whether a claimed capital loss on account of worthlessness of securities in the amount of $9,849.40 was properly disallowed for petitioner's taxable year 1949;

(6) Whether interest expense in the amount of $5,308.33 was properly disallowed for petitioner's taxable year 1950;

(7) Whether income from the Algiers Lock projects should have been reported in the amounts of $34,252.39, $87,203.91, and $31,153.01 in petitioner's taxable years 1949, 1950, and 1951, respectively, rather than in the amounts of $128,410.60 and $24,198.71 in petitioner's taxable years 1950 and 1951, respectively;

(8) Whether, in its taxable year 1955, petitioner received from the Cheatham Lock project ordinary income of $25,778.24 rather than a long-term capital gain of $48,306.44 and an ordinary loss of $22,528.20; and

(9) Whether petitioner is liable for additions to tax under section 291 (a) of the 1939 Code for failure to file income tax returns for each of its taxable years 1948 through 1954 and for failure to file personal holding company tax returns for each of its taxable years 1948, 1952, 1953, and 1954.

FINDINGS OF FACT

The facts stipulated to by the parties are incorporated herein by reference and found as stipulated.

Stevens Bros. Foundation, Inc., the petitioner herein, was incorporated under the laws of Delaware on December 31, 1942. Its principal office is located in St. Paul, Minnesota.

Petitioner's fiscal years and each of its taxable years before us end on March 31. Petitioner keeps its books and records on the cash basis, except as to its profits on the Cheatham Lock project, *infra*. It timely filed a Form 990 (exempt organization information return) for each of its taxable years 1948 through 1951 with the collector of internal revenue for the district of Minnesota; it filed a Form 990–A for each of its taxable years 1952 through 1954 with the collector of internal revenue, director of internal revenue, and district director of internal revenue for the district of Minnesota, respectively; and it filed a timely corporation income tax return for each of its taxable years 1955 through 1958 with the district director of internal revenue for the district of Minnesota. Each of the above-mentioned Form 990 and Form 990–A returns lacked data necessary for the computation and assessment of deficiencies.

Stevens Bros. & The Miller-Hutchinson Co., Inc. (hereinafter sometimes referred to as Corporation), and petitioner filed a partnership information return for the calendar year 1949 with the collector of internal revenue for the district of Louisiana and for each of the calendar years 1950 through 1954 with the appropriate collector, director, or district director of internal revenue for the district of Tennessee.

Petitioner's certificate of incorporation, which was not amended between the time of its issuance and the end of the last taxable year before the Court, reads, in pertinent part, as follows:

FIRST. The name of this corporation is STEVENS BROS. FOUNDATION INC.

* * * * * * *

THIRD. The nature of the business and the objects and purposes to be transacted, promoted and carried on are to do any or all of the things herein mentioned as fully and to the same extent as natural persons might or could do, and in any part of the world, viz.:

To engage in charitable, educational and public welfare activities of any and all kinds; and to accept and receive property of any and all kinds by gift, devise, trust agreement, bequest or otherwise.

To hold, purchase, mortgage or convey real and personal property within or without the State of Delaware; to institute, participate in, promote or carry on commercial, mercantile, financial, industrial, mining, construction and engineering enterprises and operations and to conduct all businesses appurtenant thereto.

To purchase or otherwise acquire, register, hold, use, sell or in any manner dispose of and to grant licenses or other rights and in any manner deal in and with processes, formulas, trade-marks, trade names, patents and copyrights.

* * * * * * *

The objects and purposes specified herein shall be regarded as independent objects and purposes and, except where otherwise expressed, shall be in no way limited nor restricted by reference to or inference from the terms of any other clause or paragraph of this certificate of incorporation.

The foregoing shall be construed both as objects and powers and the enumeration thereof shall not be held to limit or restrict in any manner the general powers conferred on this corporation by the laws of the State of Delaware.

FOURTH. This corporation is organized wholly for charity and is not organized for profit and is not to have authority to issue capital stock. The conditions of membership are as follows:

The four incorporators shall be members upon payment of One Dollar ($1.00) each to this corporation and upon agreement to give their services as required for five (5) years without compensation. No other person shall become a member except upon the unanimous approval of all members in attendance at the meeting passing upon the application.

Further conditions of membership, the determination of dues and other regulations governing the association, its members and officers shall be fixed in the by-laws of this corporation.

FIFTH. No part of its net income shall inure to the benefit of any member, officer, trustee or employee of the corporation, or of any individual having a personal or private interest in its activities, nor shall any such member, officer, trustee, employee or individual receive or be lawfully entitled to receive any pecuniary profit from its operation, except reasonable compensation for services rendered in carrying out, or as a proper beneficiary of one or more of its said purposes.

. . . . . .

SEVENTH. This corporation is to have perpetual existence.

. . . . . .

NINTH. The property and business of the corporation shall be managed and controlled by its board of officers, and in furtherance and not in limitation of the powers conferred by the laws of the State of Delaware, the board of officers is expressly authorized:

To make, alter, amend and repeal the by-laws.

This corporation may in its by-laws confer powers in addition to the powers the authorities expressly confer upon them by law.

. . . . . .

ELEVENTH. This corporation reserves the right to amend, alter, change or repeal any provision contained in this certificate of incorporation in the manner now or hereafter prescribed by law and all rights conferred on officers and members herein are granted subject to this reservation.

Petitioner never issued capital stock; it never carried on propaganda to influence legislation; it never participated or intervened in any political campaign on behalf of any candidate for office; and it neither paid salaries to its officers or members nor reimbursed them for expenses.

The name, office in petitioner, and relationship to Edwin Fenton Stevens (hereinafter sometimes referred to as Stevens) of each of the persons ever admitted to membership in petitioner are as follows:

Name	Office in petitioner	Relationship to Edwin Fenton Stevens
Edwin Fenton Stevens[1]	President	Self.
Sadie Augusta Stevens[1]	Secretary-treasurer	Wife.
Charles Ray Stevens[1]	General manager	Brother.
Henry Oldaker Stevens[1] (Apr. 27, 1955).	Vice president	Brother.
Blanche W. Stevens	Assistant to secretary-treasurer	Sister.
Olive G. Stevens (deceased May 7, 1954).	Assistant to vice president	Sister-in-law (wife of C. R. Stevens).
Mary E. Stevens Wissing	Second assistant to vice president.	Niece.
Helen F. Stevens Chase	Second assistant to general manager.	Niece.
Henry Orrin Stevens	Assistant to president	Nephew.
Bess M. Stevens	Assistant to general manager.	Sister-in-law (wife of Henry Oldaker Stevens).

[1] Incorporators of petitioner.

Petitioner applied in 1943 for exemption from Federal income taxes. By letter dated January 12, 1944, respondent notified petitioner that:

"Notwithstanding the provisions contained in your articles of incorporation that the objects and purposes specified shall

be regarded as independent objects and purposes, it appears that in view of paragraph Fifth all of the income realized from the exercise of the powers conferred upon you must be used for charitable purposes. In reply to item 12 of questionnaire, Form 1023, you have stated that you are not and have not been engaged in carrying on propaganda or otherwise attempting to influence legislation.

"It is the opinion of this office that if you are operated exclusively in furtherance of your stated purposes, you will be entitled to exemption from Federal income tax under the provisions of section 101 (6) of the Internal Revenue Code as an organization organized and operated exclusively for charitable purposes and will not be required to file returns of income."

By letter dated May 1, 1947, respondent notified petitioner that:

"It is the opinion of this office, based upon the evidence presented, that you are exempt from Federal income tax under the provisions of section 101 (6) of the Internal Revenue Code and corresponding provisions of prior revenue acts, as it is shown that you are organized and operated exclusively for charitable purposes.

"Accordingly, you will not be required to file income tax returns unless you change the character of your organization, the purposes for which you were organized, or your method of operation. Any such changes should be reported immediately to the collector of internal revenue for your district in order that their effect upon your exempt status may be determined."

In 1906 the four persons who later incorporated petitioner organized a partnership known as Stevens Bros. Contractors (hereinafter sometimes referred to as Partnership). All

four shared equally in Partnership's profits during the years before the Court until the death of Henry Oldaker Stevens. Thereafter, the remaining three partners shared equally in Partnership's profits during the years before the Court.

Petitioner's books of account and records are kept in ledgers separate from the individual ledgers in which the records of Partnership and Corporation are kept.

During the period April 1, 1947, to May 14, 1954, petitioner's cash was kept in a joint bank account maintained by it, Partnership, and Stevens Bros. Coal Co. The endorsement stamp used read as follows:

PAY FIRST NATIONAL BANK
1845 St. Paul, Minn. or order 1845
Stevens Bros. Coal Co.
Stevens Bros. Contractors
Stevens Bros. Foundation, Inc.
STEVENS BROS.

A separate bank account for petitioner was established after 1954 in the First National Bank of St. Paul.

Cash receipts, deposits, and disbursements records for each of the joint bank depositors were maintained by separate columnar distributions in a joint cash receipts book and disbursements books for each item of receipt, deposit, and disbursement to each joint depositor.

Corporation was chartered in Delaware in 1929, at which time it was owned in equal shares by Partnership and members of the Miller-Hutchinson Company. During the years before the Court, 1,500 shares in Corporation were owned by R. C. Hutchinson (hereinafter sometimes referred to as Hutchinson) and the remaining 3,000 shares outstanding were owned by Partnership. Hutchinson was secretary

treasurer of Corporation and Stevens was its president during all the years before the Court.

During the years before the Court, Corporation was engaged in the construction business.

In 1947 Hutchinson, who was then in active charge of Corporation and its operations, traveled to St. Paul, Minnesota, to request permission from Stevens for Corporation to bid on a contract to build the floor at the Algiers Locks, about 5 miles below New Orleans, Louisiana. Hutchinson requested such permission because the government required a bid bond and the surety company informed him it would not issue a bond on Corporation's bid unless an additional $50,000 in cash was absolutely subordinated to the contract. The bank with which Corporation normally did its business refused to lend this additional sum because Corporation's line of credit was used up.

Stevens suggested that petitioner probably had the necessary funds and might advance them. Hutchinson then spoke before petitioner's board of directors, which, at its meeting of May 29, 1947, agreed to advance the money in return for one-third of the profits before taxes, plus repayment of the advance. Petitioner was to have no authority with regard to the actual construction work.

Hutchinson then notified petitioner that the surety company had changed its mind and insisted on having $75,000 subordinated to the contract instead of the $50,000 previously required. He offered petitioner one-half the profits before taxes, plus repayment of petitioner's advance. This new agreement was accepted by petitioner's board of directors at its July 1, 1947, meeting and the earlier agreement was canceled. The bid Hutchinson submitted was accepted and petitioner advanced the $75,000 as per its agreement.

The next year petitioner advanced an additional $40,000 to pay for steel sheet piling which had to be secured before other work could be done. Petitioner received no additional consideration for the $40,000 advance. This advance was ultimately returned.

Before the Algiers Lock floor contract was completed, the contract for the erection of the walls at the same lock was opened for bidding. Corporation bid on that contract, received the award, and unsuccessfully attempted to secure a bond for the contract bid without being required to furnish additional funds. Once again, Corporation's bank would not advance any further funds.

The agreement between petitioner and Corporation covering the Algiers Lock floor was extended for the Algiers Lock wall contract and the $75,000 previously advanced by petitioner was left with Corporation pursuant to the extended agreement. No additional money was furnished by petitioner for use on the Algiers Lock wall contract.

Petitioner reported income from profits in the Algiers Lock investments in the amount of $128,410.69 on its Form 990 for its taxable year 1950, and $24,198.71 for its taxable year 1951. On its partnership returns with Corporation, petitioner reported its share of the Algiers Lock profits as $87,203.91 for calendar 1949 and $31,153.01 for calendar 1950.

Before the Algiers Lock wall contract was completed, Corporation was invited by T. L. James & Co., Inc. (hereinafter sometimes referred to as James), a contracting firm, to bid with James on the Cheatham Lock contract—a job for the lock on the Cumberland River near Ashland City Tennessee. The lock was to be a thousand feet long and the job amounted to about $5 million. The invitation was accepted and Corporation and James, jointly, were awarded the contract.

Petitioner agreed to extend the financial terms of the agreement for the Algiers Lock project (including the $75,000 investment) to the Cheatham Lock project. Subsequently, petitioner advanced the additional sums of $25,000 (August 20, 1951) and $50,000 (October 4, 1951) for use on the Cheatham Lock project.

Profits from the Cheatham Lock project were to be divided equally between James and Corporation. Half of Corporation's profits were to go to petitioner. On its corporation return for its taxable year 1955 and its partnership return with Corporation for calendar 1954, petitioner reported as its share of the Cheatham Lock profit (completed contract method) a capital gain of $48,306.44 and an ordinary loss of $22,528.20.

$19,081.95 of the capital gain was attributable to sales of equipment used on the project which had been divided between the joint contractors (Corporation and James) and subsequently sold.

The remaining $29,224.49 of the capital gain was attributable to the sale of steel sheet piling which consists of sheets of steel having interlocks on each edge whereby each successive sheet fastens onto the preceding sheet. About 3,000 tons of steel sheet piling was used in the Cheatham Lock for a temporary cofferdam. The cofferdam was for the protection of the contractors and if withdrawn before the proper time would have caused the contractors loss. The contractors transferred ownership of the steel sheet piling to the Corps of Engineers for the time that it was required on the lock. After the piling had served its purpose, it was pulled out of the job, trimmed, cut, and sold by the joint venturers.

Stevens had been engaged as an engineering contractor in the construction of railroads, highways, bridges, paving, air-

ports, and locks from 1906 to the period here involved—contracts involving many millions of dollars. Based on his experience and on knowledge of the Algiers and Cheatham Lock projects, he felt that there was no substantial risk to petitioner's investments in those contracts. He would not have invested petitioner's funds in the projects if he believed there were such risks.

The lock construction project relationship between petitioner and Corporation terminated in 1954. The $75,000 original investment and the $75,000 additional investment in the Cheatham Lock project in 1951 were returned about 1953. Petitioner received its distributive share of the Cheatham Lock project profits in 1955.

Petitioner was adequately compensated for its involvement in the Algiers and Cheatham Lock projects. No part of what should have been petitioner's profits was diverted to its members through Corporation or partnership. Petitioner's advances of money for use on the canal lock projects were not loans but rather constituted petitioner's contributions to a joint venture with Corporation.

One of the substantial purposes for petitioner's involvement in the lock construction projects was to benefit petitioner's founders, through their interest in and indirect control over petitioner's co-venturer, Corporation.

For each of its taxable years 1948, 1952 through 1954, and 1956 through 1958, 80 percent or more of petitioner's gross income was of the kind included in the definition of personal holding company income under the applicable Internal Revenue laws. For its taxable year 1955 less than 80 percent of petitioner's gross income was personal holding company income.

On March 31, 1947, petitioner acquired stock in Denver & Rio Grande Railway at a cost of $4,971.50. On November 5, 1947, petitioner acquired stock in St. Louis & San Francisco Railway at a cost of $4,877.90. Petitioner deducted these amounts on its information return for its taxable year 1949, claiming worthlessness. Stevens tried unsuccessfully to sell those securities in 1949. He believed they had no value in 1949 and none at the time of trial. On its information return for its taxable year 1952 petitioner included a gain from the sale of "Denver and Rio Grande 5s of 55 bonds" for $10,272.60 on June 5 and 15, 1951. The return indicates the bonds were purchased on December 8, 1947, for $4,166.80.

Partnership loaned certain sums of money to petitioner during the period beginning in February 1946 and ending in October 1953. The total outstanding on the first day of any month during that period ranged from $496,973.71 to $969,211.62 and averaged $783,266.59 for that period.

Petitioner paid no interest on those loans outstanding during its taxable years 1946 through 1948. Partnership charged no interest because its members had established petitioner and were interested in seeing it secure funds with which to operate.

Petitioner paid interest to Partnership amounting to $19,200 during each of its taxable years 1949, 1951, 1952, and 1953, and $9,600 during its taxable year 1954. These amounts were "rounded off" without regard to the varying amounts of the loans.

Petitioner paid interest on those loans in the amount of $24,508.33 during its taxable year 1950, amounting to the "established rate" of $19,200 plus an excess of $5,308.33, which arose out of efforts undertaken by petitioner's officers to see whether it could borrow funds from other parties. This

$5,308.33 charge was for funds borrowed in connection with such efforts. Partnership's members (who are also the officers of petitioner) determined this excess amount was charged to petitioner in error and that they would repay the amount to petitioner, but they had not yet repaid as of the date of the trial.

Partnership charged interest for those fiscal years because its members believed petitioner had reached the point where it could afford to pay interest.

Since 1954 petitioner has not borrowed funds from Partnership or from any other source and has not paid any interest to Partnership.

A patent issued in Stevens' name was secured for petitioner for a heating device at a cost to petitioner of $180. It was secured so petitioner could license its use and also distribute the device for therapeutic purposes.

Experimental designs were developed and experimental heaters were constructed by Partnership. The material costs incurred by Partnership were treated as a gift by it to petitioner and half the heaters manufactured were turned over free of cost to petitioner for its purposes. Petitioner distributed its heaters to hospitals, old folks' homes, and individuals (including at least seven relatives and business and social acquaintances of Stevens) for therapeutic and experimental purposes. About 100 heaters were distributed.

An arbitrary value was assigned to the experimental heaters and the value so assigned was reflected in petitioner's books as the amount in dollars included among the contributions, gifts, and grants made by it. Although most of the heaters were donated in this manner, some were sold. The aggregate value of the contributions, gifts, and grants of the

experimental heaters as reflected in the book of the Foundation consisted of $2,300 during the period ending before April 1, 1947, and $2,210.25 after that date.

It was concluded that the patent had little value since only 2 of the 22 uses sought in the patent application were granted.

Petitioner began making educational loans to college students about 1952. The students selected to receive aid were senior students, most of whom attended Minnesota colleges. The students signed notes in order to obtain these loans. However, repayment was waived in the case of most or all of the 32 loans, totaling $4,605, made during petitioner's taxable years 1953 through 1955. The first of these loans was forgiven on December 20, 1952, although the student was not notified until a year or more later.

For its taxable years 1956 through 1958 petitioner made 36 loans, totaling $7,496. Loan terms are extended without question whenever a student advances a good reason for delay in payment. No student has defaulted or failed to repay any of the loans made during petitioner's taxable years 1956 through 1958.

Petitioner's books indicate receipts, disbursements, and student loans in the following amounts:

Fiscal year through—	Contributions received	Other income	Expenses	Contributions, gifts, grants, etc.	Student loans	Surplus balance
1947	$36,038.75	$69,573.00	$139.87	$4,227.50		$201,244.38
1948	58.00	87,752.98	27.00	1,245.25		187,783.11
1949		85,024.83	19,315.75	235.00		203,257.19
1950	1,200.00	180,271.85	24,715.33	1,825.00		358,188.71
1951		94,907.41	19,237.00	1,000.00		432,919.12
1952		73,782.91	19,230.00	1,250.00		486,222.03
1953	105.00	38,212.89	19,295.00	2,090.00		503,154.92
1954		19,741.79	9,830.00	3,981.84		509,545.07
1955	1.00	20,679.41	1,450.00	2,015.00		526,550.48
1956	4.00	14,340.00	1,392.26	2,150.00	$770	537,339.22
1957		24,278.26	3,671.00	1,600.00	1,725	556,446.54
1958	23,879.70	25,134.82	2,050.55	1,725.00	5,001	601,685.51

[1] Of these sums the following amounts were student loans that were forgiven: 1953—$2,090; 1954—$1,500; 1955—$1,015.

Petitioner's members planned to accumulate in petitioner $1 million, from which they calculated petitioner could be expected to derive an annual income of $50,000. They expected this to be sufficient to meet petitioner's expenses and have a significant sum available for charitable purposes. This plan was determined on or before August 20, 1953.

At the time of the trial herein, petitioner's investments had a total value of $950,000.

On information returns for each of its taxable years 1948 through 1954 petitioner answered "no" to the following question:

Have you had any sources of income or engaged in any activities which have not previously been reported to the Bureau? _____ If so, attach detailed statement.

(Yes or no)

Except for the matters noted immediately below and the partnership returns referred to at the outset of these findings of fact, petitioner had not previously informed respondent of its participation in the canal lock construction projects.

Petitioner's information returns for its taxable years 1950 and 1951 listed income from "Algiers Lock Investment" as "other income," a category that had not been used by petitioner in its information returns for the four immediately preceding taxable years.

Petitioner's information return for its taxable year 1952 listed in a balance sheet the item "Algiers Lock Investment." Balance sheets did not accompany petitioner's information returns for the 6 immediately preceding years.

Petitioner's information returns for its taxable years 1953 and 1954 listed in balance sheets the item "Cheatham Lock Investment."

By letter dated August 24, 1954, respondent notified petitioner that:

"On the basis of the information before us it cannot be said that you have been organized and operated exclusively for one or more of the purposes stated in section 101(6) of the Code. You have expended only a nominal amount of your income for the charitable purposes on which your tax-exempt status was based. Instead your operations have consisted primarily of trading in securities with funds borrowed from your founders and you have either used the income earned for loans to them in their business ventures or have credited it to surplus.

"Though the Service is not unmindful of the necessity, from the standpoint of charitable organizations, of acquiring income-producing investments, it is not believed that the funds of an exempt organization should be used indefinitely in the manner set forth above, particularly when the use thereof directly or indirectly benefits its founders.

"Accordingly, our ruling of May 1, 1947, is hereby revoked. You are required, therefore, to file income tax returns on Form 1120.

"The District Director of Internal Revenue at St. Paul, Minnesota, is being furnished a copy of this ruling."

By letter dated September 8, 1954, the district director at St. Paul notified petitioner that:

"Inasmuch as the National Office, Washington, D.C. under date of August 24, 1954, revoked its ruling of May 1, 1947 granting your foundation exemption under Section 101(6) of the Internal Revenue Code, your organization is now liable for Federal corporation income tax returns.

"There are enclosed for your use Forms 1120 for the years 1948 to 1953, inclusive."

Prior to August 24, 1954, Stevens had not been advised by respondent either that petitioner's returns were not filed on time or that it was engaged in activities not proper for a tax-exempt organization.

After receiving the revocation notice, Stevens made unsuccessful efforts to secure an explanation for the revocation satisfactory to him. Stevens then consulted an attorney, but still could not determine the cause for revocation. Stevens asked the attorney for an opinion as to petitioner's tax-exempt status. After receiving the opinion Stevens was not able to determine whether any of petitioner's activities conflicted with its claimed tax-exempt status.

As of the time of the trial, no corporate tax returns had been filed by petitioner for its taxable years 1948 through 1954.

OPINION

Issue 1. Statute of Limitations

By timely amendment to its petition, petitioner claims that the statute of limitations [2] bars assessments of deficiencies for its taxable years 1948 through 1954. As to its taxable

[2] SEC. 275. [1939 Code] PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.

Except as provided in section 276—

(a) General Rule.—The amount of income taxes imposed by this chapter shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period.

years 1948 through 1951, petitioner relies also upon section 302(b) of the Revenue Act of 1950.[3]

Respondent relies upon section 276(a) of the 1939 Code [4] and argues that the information returns filed by petitioner are not such returns as will start the running of the statute of limitations. Respondent maintains petitioner is to be denied exemption for a variety of reasons other than and in addition to the reason that it was carrying on a trade or business for profit. Respondent maintains that under these circumstances section 302(b) of the Revenue Act of 1950 is, by its terms, of no assistance to petitioner.

We agree with respondent.

Petitioner filed timely information returns for the first 4 years before us and it is not disputed that these were the returns required by section 54(f) of the 1939 Code. The deficiency notice was mailed to petitioner on June 14, 1960, more than 9 years after the last of the information returns for the 4 earliest years was received by respondent. However, our

[3] SEC. 302. EXEMPTION OF CERTAIN ORGANIZATIONS FOR PAST YEARS.

(b) Period of Limitations.—In the case of an organization which would otherwise be exempt under section 101 of the Internal Revenue Code were it not carrying on a trade or business for profit, the filing of the information return required by section 54(f) of the Internal Revenue Code (relating to returns by tax-exempt organizations) for any taxable year beginning prior to January 1, 1951, shall be deemed to be the filing of a return for the purposes of section 275 of the Internal Revenue Code (relating to period of limitation upon assessment and collection). * * *

[4] SEC. 276. SAME—EXCEPTIONS.

(a) False Return or No Return.—In the case of a false or fraudulent return with intent to evade tax or of a failure to file a return the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.

decision, *infra*, that petitioner was not exempt from income taxation during those 4 years for reasons other than that it engaged in a trade or business for profit, eliminates petitioner from the protection of section 302(b) of the Revenue Act of 1950.

Petitioner's other argument is also of no avail since the information returns filed by petitioner for its taxable years 1948 through 1954 in compliance with section 54(f) of the 1939 Code lack data necessary for the computation and assessment of deficiencies and therefore do not constitute "returns" for the purposes of section 275(a) of the 1939 Code. *Automobile Club v. Commissioner*, 353 U.S. 180, 187-188 (1957).

On this issue we hold for respondent.

Issue 2. Retroactive Revocation

Respondent suggests this Court is without power to review retroactive revocations of rulings under section 7805(b)[5] of the 1954 Code.[6] Respondent argues that even if this Court may review his actions, it can do so only where he has abused the discretion granted by the statute. He maintains that there has been no abuse here "since petitioner concealed certain facts and made misrepresentations to the respondent." Petitioner replies there is no doubt of this Court's power to review respondent's action. Petitioner maintains that it

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[5] SEC. 7805. RULES AND REGULATIONS.

(b) Retroactivity of Regulations or Rulings.—The Secretary or his delegate may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect.

[6] Since the certificate was revoked on August 24, 1954, after enactment of the 1954 Code (Aug. 16, 1954), the 1954 Code provision applies. Sec. 7831(a)(6)(C)(viii), 1954 Code. In any event, section 3791(b) of the 1939 Code is substantially the same.

reported all its income from construction contracts when received according to the method by which it kept its books. Petitioner did not note on its returns that it engaged in business because it did not and does not now believe that it did engage in business.

We agree that respondent did not err in retroactively revoking petitioner's certificate of exemption.

Whatever the nature of the limitations imposed on respondent when he issues a ruling or otherwise acts with regard to a particular taxpayer, it is clear that those limitations apply only to situations of which respondent has been made aware. Respondent is not barred from changing his rulings retroactively where he was not fully or correctly informed as to the material facts upon which the rulings were based or where there have been material changes in law or fact subsequent to the time respondent acted. *Birmingham Business College, Inc. v. Commissioner*, 276 F. 2d 476 (C.A. 5, 1960), affirming a Memorandum Opinion of this Court; *Southern Maryland Agricultural Fair Association*, 40 B.T.A. 549 (1939); *United States v. La Societe Francaise de Bien, Mat.*, 152 F. 2d 243, 246 (C.A. 9, 1946). *See Automobile Club v. Commissioner, supra; Massaglia v. Commissioner*, 286 F. 2d 258 (C.A. 10, 1961), affirming 33 T.C. 379 (1959).

The facts which cause us to determine, *infra*, that petitioner was not exempt during the years before the Court all occurred after respondent issued his letter ruling which granted exemption. None of those facts was described to respondent before he issued that ruling. Since respondent was not adequately informed of the changes in petitioner's activities and purposes we cannot impute any significance here to the fact that respondent did not revoke his ruling until 1954. *See Automobile Club v. Commissioner, supra* at 186.

Petitioner notes that in *Birmingham Business College, Inc., supra*, the Court of Appeals sustained respondent's right to revoke when the original certificate was based on material misrepresentation. Petitioner argues that the disagreement over whether repayment of petitioner's first educational loan was forgiven in 1952 or in 1954 does not involve a material misrepresentation. Petitioner is correct in that the date of forgiveness of the loan is not material to our decision in this case. However, petitioner's entry into the joint ventures with Corporation and the provisions of the Revenue Act of 1950 regarding improper accumulations were material events occurring after the issuance of petitioner's exemption certificate. See Issue 3, *infra*. Since the ruling here relied upon (set forth in the Findings of Fact, *supra*) did not purport to cover changed conditions, it is immaterial whether the changes involved misrepresentations. Accordingly, the only relevance of *Birmingham Business College, Inc.* is to emphasize that respondent may retroactively revoke his rulings where the facts differ in some material respect from the information on the basis of which respondent issued his rulings.

Petitioner maintains that respondent discriminates between taxpayers similarly situated. Petitioner states on brief that in *Leon A. Beaghly Fund*, 35 T.C. 190 (1960), (on appeal by the Government (C.A. 6, June 9, 1961)), "the Commissioner revoked an exemption letter, not back to the issuance of the exemption letter, but from and after a date when the petitioner had entered into a certain transactions. In disposing of deficiencies asserted after that revocation the Court decided that the petitioner was not exempt, not for the years 1945 and subsequent years referred to in the notice of revocation, but for the year 1949 when the taxpayer executed the last step in a series of transactions that began with the year 1945." In *Beaghly*, as here, the certificate was revoked retro-

actively to the year in which the activities changed. It happens that in this case the material change in petitioner's activities occurred in the same taxable year that petitioner received its exemption certificate, while in *Beeghly* it occurred some years after that taxpayer received its certificate.[7] Since this Court's jurisdiction in *Beeghly* was based upon a deficiency notice for the year 1949 only, we could not make a binding determination in that case as to exemption for any year other than 1949. We are not privy to the Commissioner's thoughts in *Beeghly* in issuing a deficiency notice for 1949 only, but we note that much of that taxpayer's income was held by various courts until released to it in 1949. We cannot determine whether the taxpayer in that case should have paid taxes for any year prior to 1949. Since we are not persuaded that respondent has discriminated between petitioner and *Beeghly*, we need not consider what if any effect such alleged discrimination, if proven, would have on this proceeding. Cf. *City Loan and Savings Company v. United States*, 177 F. Supp. 843, 851 (N.D. Ohio 1959), aff'd. 287 F. 2d 612 (C.A. 6, 1961).

Petitioner notes that section 302(b) of the Senate version of the Revenue Bill of 1950 (Amendment No. 157, p. 190, of Senate Print H.R. 8920) prohibited, as to years prior to 1951, retroactive revocation of exemption certificates. As petitioner also notes, that restriction was not enacted. Conf. Rept., H. Rept. No. 3124, pp. 14, 35 (Sept. 21, 1950), 1950-2 C.B. 390. However, even had that restriction been enacted it would not

[7] On or about June 23, 1948, respondent revoked the taxpayer's exemption certificate retroactive to December 28, 1945, the date on which the taxpayer had entered into the transactions which caused it to lose its exempt status. See Issue 3, **infra**. The exemption certificate had been issued August 12, 1941. 35 T.C. at 495.

have helped petitioner, since it was limited by its terms to revocation of an organization's exempt status "on the ground that it is carrying on a trade or business for profit." The Senate report (No. 2375, p. 118 (Aug. 22, 1950), 1950-2 C.B. 567) states in this regard that "section 302 applies only where a denial of exemption might be made on the ground that the organization was carrying on a trade or business for profit, and nothing therein limits the denial of exemption for failure to meet other requirements of section 101."

Petitioner relies upon the opinion of the Court of Appeals for the Third Circuit in *Lesavoy Foundation v. Commissioner*, 238 F. 2d 589 (C.A. 3, 1956), reversing 25 T.C. 924 (1956), regarding when the Commissioner may be said to have abused his discretion. In that case the Court of Appeals was strongly influenced by its view that "The Commissioner's theory is a debatable one at best" (238 F. 2d at 593); the fact that the taxpayer fully disclosed its purchase of a cotton mill and provided information from which it might have been concluded that it did business with its donors (*id.* at 592); and the fact that the deficiency and additions would have exceeded the taxpayer's total assets. *Id.* at 594. See *Kolinsky v. United States*, 271 F. 2d 865, 868 (C.A. 2, 1959). These circumstances lead us to conclude that the Court of Appeals decision in *Lesavoy* is distinguishable from the instant case and does not require us to estop respondent from asserting deficiencies which we here hold are, in part, properly asserted.

Since we determined that the circumstances of this case do not warrant estopping respondent from retroactively revoking the certificate, we need not decide whether we have jurisdiction to determine that respondent may be estopped from doing so. See *Lorain Avenue Church*, 31 T.C. 141, 165 (1958).

On this issue we hold for respondent.

Issue 3. Exemption

Respondent advances a number of arguments to support his contention that petitioner is not exempt from taxation. At this point we will consider only two: (1) Petitioner was not operated exclusively for tax-exempt purposes since its involvement in the Algiers and Cheatham Lock projects resulted in substantial commercial benefits to its members and (2) the sums petitioner accumulated out of income and did not actually pay out during the taxable years before the Court were unreasonable in amount and duration in order to carry out its charitable purposes.

Petitioner claims to be exempt from taxation under the provisions of sections 501(c)(3) of the 1954 Code* and

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*SEC. 501. EXEMPTION FROM TAX ON CORPORATIONS, CERTAIN TRUSTS, ETC.

(a) Exemption From Taxation.—An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502, 503, or 504.

* * * * * * * *

(c) List of Exempt Organizations.—The following organizations are referred to in subsection (a):

* * * * * * * *

(3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, * * * or educational purposes, * * * no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

101(6) of the 1939 Code.[9] It stresses the bona fide nature of its involvement in the construction contracts and the reasonableness of accumulating $1 million in order to achieve a sufficiently high level of earnings to accomplish its charitable purposes.

We agree with respondent that petitioner was not operated exclusively for tax-exempt purposes during its taxable years 1948 through 1955 and that it unreasonably accumulated income during its taxable years 1952 through 1958.

Operated Exclusively for Tax-Exempt Purposes

In order to be exempt from taxation under the provisions set forth in the margin, petitioner must satisfy each of the requirements of (1) operation and organization exclusively [10] for the listed exempt purposes, (2) no inurement of net earnings to the benefit of individuals or stockholders, and (3) no

[9] SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS.

The following organizations shall be exempt from taxation under this chapter—

* * * * * * *

(6) Corporations, and any * * * foundation, organized and operated exclusively for religious, charitable, * * * or educational purposes, * * * no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation;

Section 332(c) of the Revenue Act of 1950 amended this provision by replacing the final semicolon with a period and adding the following after the period:

For loss of exemption under certain circumstances, see sections 3813 and 3814;

[10] "Exclusively," in this context, means that there is no non-exempt purpose that is "substantial in nature." Better Business Bureau v. United States, 326 U.S. 279, 283 (1945).

political activity or substantial lobbying activity.[11] Since the requirements are in the conjunctive, failure to satisfy any one of them causes a loss of tax exemption.

In *Leon A. Beeghly Fund, supra*, the Fund, which already owned 151 shares of Cold Metal Process Co., purchased the remaining 1,849 shares of Cold Metal, liquidated it, sold the stock of a subsidiary of Cold Metal, sold various other assets, and succeeded to the litigation of Cold Metal, from all of which it obtained a substantial profit. The other shareholders of Cold Metal, who had been negotiating with a view toward selling their stock to certain steel companies, had encountered difficulties, among them the insistence of the prospective purchasers that the transaction be completed before expiration of the World War II excess profits tax and the reluctance of those purchasers to acquire the subsidiary. Our conclusion (*id.* at 519) was unanimous on this issue:

"it is clear that the trust was brought into this transaction for the primary purpose of permitting the stockholders of Cold Metal to settle with the steel companies for the amount agreed upon in such a manner that they would have something left after taxes, and we think that in entering into the transaction for that purpose the trust was being operated other than exclusively for charitable purposes within the intent of the statute, and that when it continued to be used in the year 1949 in carrying out this transaction, it was also being operated for other than exclusively charitable purposes."

Petitioner's involvement in the Algiers Lock floor project met Corporation's pressing need for cash. Petitioner was not

[11] Respondent does not contend petitioner has failed to meet the third test.

approached until Corporation had been turned down by both its bank and the bonding company. Petitioner's founders controlled Corporation through Partnership. Petitioner could not benefit from the transaction unless Corporation, and therefore petitioner's founders, also benefited. These facts lead us to conclude that petitioner's involvement in the project was to a substantial extent an effort to benefit its founders. Petitioner's involvement in the Algiers Lock wall contract and the Cheatham Lock contract were, in purpose and effort, continuations of involvement in the Algiers Lock floor contract. On the basis of *Beeghly* we hold that for the years during which petitioner was involved in the Algiers and Cheatham Lock projects it was not operated exclusively for tax-exempt purposes. See *Horace Heidt Foundation*, 145 Ct. Cl. 322, 170 F. Supp. 634 (1959).

We have found petitioner's involvement in the lock construction projects ended some time in 1954. We have not been able to determine when in 1954 this occurred. Petitioner has not persuaded us that this occurred before March 31, 1954, the end of its taxable year 1954, and we therefore hold that petitioner was not operated exclusively for tax-exempt purposes during its taxable years 1948 through 1955.

Unreasonable Accumulations

Section 3814 of the 1939 Code[12] was added by section 331 of the Revenue Act of 1950 and made applicable by section 333 of that Act to taxable years beginning after December 31, 1950. Section 504(a) of the 1954 Code is, for our purposes substantially a reenactment of section 3814 of the 1939 Code.[13] Petitioner, if it is exempt from taxation, is exempt only under section 101(6) of the 1939 Code or section 501 (c)(3) of the 1954 Code. Petitioner is not excepted by the provisions of section 3813(a) of the 1939 Code or 503(b) of the 1954 Code from the application of either sections 3813 or 503, respectively. Consequently, sections 3814 of the 1939

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[12] SEC. 3814. DENIAL OF EXEMPTION UNDER SECTION 101(6) IN THE CASE OF CERTAIN ORGANIZATIONS ACCUMULATING INCOME.

In the case of any organization described in section 101(6) to which section 3813 is applicable, if the amounts accumulated out of income during the taxable year or any prior taxable year and not actually paid out by the end of the taxable year—

(1) are unreasonable in amount or duration in order to carry out the charitable, educational, or other purpose or function constituting the basis for such organization's exemption under section 101(6); or

(2) are used to a substantial degree for purposes or functions other than those constituting the basis for such organization's exemption under section 101(6); or

(3) are invested in such a manner as to jeopardize the carrying out of the charitable, educational, or other purpose or function constituting the basis for such organization's exemption under section 101(6),

exemption under section 101(6) shall be denied for the taxable year.

[13] References in section 3814 of the 1939 Code to sections 101(6) and 3813 are replaced in section 504(a) of the 1954 Code by references to 501(c)(3) and 503, respectively. The exceptions embodied in the last two sentences of section 504(a) are not applicable to this case.

Code and 504(a) of the 1954 Code are at least initially applicable to petitioner.

Since it is clear that for each of the years before the Court to which sections 3814 and 504(a) are applicable (petitioner's taxable years 1952 through 1958) petitioner had substantial accumulations out of income for that year or prior years, the only issue is whether the accumulations were unreasonable in amount or duration in order to carry out petitioner's tax-exempt purposes.

For an understanding of what constitutes an unreasonable accumulation for purposes of these sections both parties rely upon *Samuel Friedland Foundation* v. *United States*, 144 F. Supp. 74, 92 (D.N.J. 1956), where the court stated:

> "What the true test appears to be is this.—Does the charitable organization have a concrete program for the accumulation of income which will be devoted to a charitable purpose and in the light of existing circumstances is the program a reasonable one?"

In *Friedland*, the taxpayer had been in operation only 3 years. It had a specific objective—accumulation of $500,000 for a medical research building for Brandeis University. This objective was determined during its first year of operation. *Id.* at 80. The court estimated this goal was likely to be reached in 6 or 7 years from the creation of the foundation. *Id.* at 93. Although "excess" accumulations totaled only $39,000 for the organization's first 3 years, contributions by it totaled $50,000. *Id.* at 91, 92.

Here petitioner has been in existence 15 years (as of the end of the last taxable year before the Court). No functional objective appears from the record. We are not told when the $1 million asset goal testified to by petitioner's

president was determined. In recent years petitioner ha embarked on a student loan program but no substantial effort is made to relate the needs of that program to the $1 million goal. Neither petitioner's charter, bylaws, nor the minutes of the meetings of its members or officers, nor any other part of the record indicates any particular use to which either the accumulated income or the then current income would be put.

If we adopt the approach of *Friedland* in determining the amount of "excess" accumulations—earned income (other than capital gains), less expenses and contributions—we arrive at excess accumulations for the years before the Court, *per petitioner's books*, as follows:

Year	Earned income other than capital gains	Expenses	Contributions	"Excess" accumulations	
				Year	Cumulative
1948	$34,762.23	$27.00	$7,245.25	$33,489.98	$33,489.98
1949	49,009.81	19,315.75	235.00	29,459.06	62,949.04
1950	180,271.85	24,715.33	1,825.00	152,731.52	216,680.56
1951	94,967.41	19,237.00	1,500.00	74,730.41	291,410.97
1952	67,677.11	19,230.00	1,250.00	47,197.11	338,608.08
1953	55,368.00	19,295.00	2,090.00	33,983.00	372,591.08
1954	40,052.09	* 630.00	3,931.64	26,490.45	399,081.53
1955	(2,765.62)	1,450.00	2,015.00	(6,230.62)	392,850.91
1956	14,081.00	1,392.29	2,150.00	10,538.80	403,389.71
1957	24,278.26	3,571.00	1,500.00	19,167.26	422,486.97
1958	24,650.92	2,050.55	1,725.00	20,875.37	443,372.34

* Treats construction contract income as ordinary loss and capital gain, per petitioner's corporate income tax return.

On every count petitioner's accumulations seem to be unreasonable as to time and amount.[11]

This Court had occasion to apply sections 381 and 504 in *A. Shiffman*, 32 T.C. 1073 (1959). There a foundation borrowed amounts totaling $1 million with which it purchased income-producing property during its first year of operation;

[11] This method, in which the facts have been viewed in the light most favorable to petitioner, shows a negative accumulation for petitioner's taxable year 1955. However, the statute penalizes unreasonable accumulations out of income for the taxable year or any prior year if the amounts have not been paid out by the end of the taxable year.

The notes were paid off in 5 years, during which time the foundation also distributed $235,071.95 to charitable organizations. In addition, the foundation pledged itself to two long-term projects: $250,000 to Brandeis University for a building project and $50,000 to Sinai Hospital of Detroit. *Id* at 1077. This Court concluded: "Assuming, but not deciding, that the use of income, year by year, to pay an indebtedness incurred in acquiring income-producing property constitutes an accumulation of income, such accumulation here involved is neither unreasonable nor for substantially nonexempt purposes." *Id.* at 1081.

In *Erie Endowment v. United States*, 202 F. Supp. 580 (W.D. Pa. 1961), on appeal (C.A. 3), the court was faced with an inter vivos trust which provided, among other things, that certain percentages of each year's trust income would be added to corpus until the additions plus original corpus totaled $10 million.

The court held that the trust violated the unreasonable accumulations provision of section 504(a) of the 1954 Code (*id.* at 582-583):

> [b]ecause there are no specific projects or objectives for which the income was accumulated. * * * The court is well acquainted with and has a great respect for the integrity and ability of [the trustees] * * *. The principle and main purpose of the trust in the first instance, however, must be held to be the accumulation of $10,000,000.00. When that goal is reached, then something worthwhile can be undertaken. As indicated, it is apparent that the purposes and objectives of the trust in the first instance were and continue to be laudable, but under the circumstances the substantial income cannot be held to be exempt from taxation. * * *

The recently decided case of *Hulman Foundation, Inc.* v. *United States*, — F. Supp. — (S.D. Ind. 1962), consistently with the cases cited above, held that the taxpayer was accumulating income largely in order to construct a civic building for Vigo County, Indiana, that this purpose was consistent with its tax-exempt status, and that the amounts accumulated were not unreasonable to carry out this specific exempt purpose.

Based on the statutory provisions hereinabove discussed, the reasoning and fact situations of the *Shiffman*, *Friedland*, *Erie Endowment*, and *Hulman* cases, and the facts disclosed by the record here, we conclude that during each of its taxable years 1952 through 1958 the amounts petitioner accumulated out of the income of that year and prior years and not actually paid out before the end of that year were unreasonable in amount and duration in order to carry out its tax-exempt purposes.

Petitioner cites to us *A. Shiffman, supra*; *Alan Levin Foundation*, 24 T.C. 15 (1955); *Ohio Furnace Co.*, 25 T.C. 179 (1955); and *John Danz Charitable Trust*, 32 T.C. 469 (1959), affd. 284 F. 2d 726 (C.A. 9, 1960), for the proposition that "the touchstone of exemption is not the amount of a fund or the period of accumulations, but whether that which is retained and not distributed serves the purpose for which the organization was formed."

In *Shiffman* the accumulation was to pay off an obligation incurred in acquiring the very property which produced the income being accumulated and we there expressed some doubt that that constituted the sort of accumulation contemplated by the statute. In any event, the foundation there had specific, reasonable goals and also made substantial current contributions out of its income.

None of the remaining three cases cited by petitioner depended upon the unreasonable accumulation provisions here at issue. All the years involved in *Levin* and *Ohio Furnace* were prior to the effective date of section 3814 of the 1939 Code. Two of the years before this Court in *Danz* were subsequent to the effective date of section 3814. However, in that case neither in the pleadings nor on brief did the Commissioner argue that that provision was applicable. The comment in *Ohio Furnace*, quoted in *Shiffman*, 32 T.C. at 1079, that "Certainly there is no requirement that the income must either be used or distributed in the year realized for the described purpose, and we know of no case wherein a corporation, fund, or foundation was denied exempt status merely because it accumulated its income for distribution in a succeeding or later year" does not have relevance here in view of the existence and applicability of sections 3814 of the 1939 Code and 504(a) of the 1954 Code and the fact that the Commissioner here does raise the issue that those sections operate to deny exempt status to petitioner.

Petitioner advances the argument that after respondent revoked the exemption certificate prudence dictated that petitioner accumulate income with which to pay any taxes for which petitioner might reasonably be held liable. Petitioner notes that its accumulated surplus increased by only $892,350.44 during its last 4 taxable years before the Court, while respondent has asserted deficiencies and additions to tax totaling $104,076.95 for that same period. How can it be said, argues petitioner, that an accumulation of amounts less than the taxes sought by respondent is an unreasonable accumulation?

Since the record is barren of evidence that the accumulations were in fact made pursuant to a program to set aside

funds to pay a possible tax liability, petitioner's argument amounts to this: We now have something we can do with our income, therefore it is reasonable for us to have accumulated it.

This argument would make the unreasonable accumulations provision completely ineffective for it would leave organizations free to accumulate income without having any purpose, secure in the knowledge that any challenge to its exempt status on account of its accumulations could always be met by a last-minute *ex post facto* decision on its part. There is no warrant for so emasculating the unreasonable accumulations provision. The statutory language seems opposed to it, the decision in *Eric Endowment* is clearly contra, and the opinions in *Shiffman*, *Friedland Foundation*, and *Hulman* do not require such a result.

We conclude that for each taxable year both current accumulations and accumulations out of the income of prior years must be supported by a currently existing program justifying such accumulations. Afterthoughts will not suffice.

In view of our decision for the reasons above stated, it is not necessary to determine whether petitioner was organized exclusively for tax-exempt purposes; whether petitioner engaged in a trade or business to such an extent that it could not be said to be operated exclusively for tax-exempt purposes; whether petitioner's investments in the construction projects so jeopardized its funds as to constitute operation for a nonexempt purpose or an improper accumulation under sections 3814(3) of the 1939 Code and 504(a)(3) of the 1954 Code; and whether petitioner's "vague charitable design" caused it to fail the "organized and operated exclusively" test.

On the issue of exemption from Federal income taxation we find for respondent as to all the years before the Court.

Issue 4. Personal Holding Company

Respondent determined that for each of petitioner's taxable years 1948 and 1952 through 1958 petitioner was a personal holding company within the meaning of sections 501(a) of the 1939 Code[15] and 542(a) of the 1954 Code.[16] Petitioner concedes it had the required percentage of personal holding company income for each of those years except 1955. During all the years petitioner had no more than 10 members, each with an equal voice in its affairs. Petitioner concedes the family relationships between the members sufficient to bring the ownership attribution rules[17] into effect so that more

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[15] SEC. 501. DEFINITION OF PERSONAL HOLDING COMPANY.

(a) General Rule.—For the purposes of this subchapter and chapter 1, the term "personal holding company" means any corporation if—

(1) Gross income requirements.—At least 80 per centum of its gross income for the taxable year is personal holding company income as defined in section 502; * * * and

(2) Stock ownership requirement.—At any time during the last half of the taxable year more than 50 per centum in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals.

[16] For our purposes section 542(a) of the 1954 Code is essentially a reenactment of section 501(a) of the 1939 Code.

[17] SEC. 503. [1939 Code] STOCK OWNERSHIP.

(a) Constructive Ownership.—For the purpose of determining whether a corporation is a personal holding company, insofar as such determination is based on stock ownership under section 501(a)(2), section 502(e), or section 502(f)—

* * * * * * *

(2) Family and partnership ownership.—An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family or by or for his partner. For the purposes of this paragraph the family of an individual includes only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

Section 544(a)(2) of the 1954 Code is, for our purposes, essentially a reenactment of section 503(a)(2) of the 1939 Code.

than 50 percent of petitioner's memberships were "owned" by not more than five individuals during the latter half of each of the years before us on this issue.

Petitioner's first argument is that it is an exempt organization thereby excepted from the definition of personal holding company. Sec. 542(c)(1), 1954 Code; sec. 501(b)(1), 1939 Code. We have decided this issue adversely to petitioner. See Issue 3, *supra*.

Petitioner's second argument is that since its charter forbids the issuance of stock and no stock in fact was issued or outstanding during any of the years before the Court, the 50-percent stockholding requirement (secs. 501(a)(2), 1939 Code, and 542(a)(2), 1954 Code) is not satisfied. Petitioner cites Rev. Rul. 58-556, 1958-2 C.B. 355, in which the Commissioner determined that memberships in an Indiana nonstock, nonprofit foundation which had lost its tax exemption would not be treated as stockholdings for personal holding company tax purposes.

Respondent relies on petitioner's reserved power to amend its charter, alleges a right of petitioner's members to share in its property on dissolution, and suggests the general equivalence of stockholders in stock corporations with members in nonstock corporations. Respondent distinguishes the cited revenue ruling on the ground that the applicable Indiana law (General Not For Profit Corporation Act) forbids the transfer of earnings from the corporation to its members and provides for escheat to the State of surplus assets on liquidation. Respondent argues that, since the applicable Delaware law does not similarly restrict petitioner's actions, petitioner's members have beneficial interests equivalent to stockholdings for personal holding company tax purposes.

Petitioner replies its charter was not amended and denies that the general equivalence of stockholders in stock corpora-

tions with members in nonstock corporations applies in all circumstances or all jurisdictions; and further, that on dissolution, application of the *cy pres* doctrine will keep petitioner's property devoted to charitable uses. Finally, petitioner argues, its reserved power to amend its charter does not permit an amendment which will change the basic purposes of the corporation and any amendment to give it the power to distribute profits or liquidate for its members' benefit would be such a prohibited amendment.

We agree with petitioner that for its taxable year 1948 its memberships do not correspond to stockholdings for personal holding company tax purposes. As to the other years before us on this issue, we agree with respondent that the stock ownership requirement has been satisfied.

Both the 1939 (sec. 3797(a)(7)) and the 1954 (sec. 7701(a)(7)) Codes define "stock" to include "shares in an association, joint-stock company, or insurance company." Neither party refers to that definition and the definition is not helpful in determining whether petitioner's memberships constitute stock for personal holding company purposes.

Both parties agree that the use of the label "membership" does not necessarily mean petitioner has no stock and that we must examine the characteristics of memberships in petitioner in order to determine if we are to treat them as stockholdings for personal holding company purposes.[18] See *Collateral Equities Trust*, 39 B.T.A. 834, 839 (1939).

The personal holding company tax provisions were first enacted in the Revenue Act of 1934 as a supplement to the

[18] The converse, that something denominated "stock" might nevertheless not constitute stock for personal holding company purposes, is not before us and we express no opinion on that issue.

accumulated earnings surtax. Both had the purpose of forcing corporations to distribute after-tax earnings to stockholders (ultimately, individuals and trusts), who would then be taxed at the sharply graduated individual income surtax rates.[19]

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[19] H. Rept. No. 704, 73d Cong., 2d Sess., p. 11 (Feb. 12, 1934):

"Perhaps the most prevalent form of tax avoidance practiced by individuals with large incomes is the scheme of the "incorporated pocketbook." That is, an individual forms a corporation and exchanges for its stock his personal holdings in stock, bonds, or other income-producing property. By this means the income from the property pays corporation tax, [sic] but no surtax is paid by the individual if the income is not distributed.

* * * * * * *

"It is true that section 104 of the existing income-tax law puts a 50-percent penalty on this accumulation of profits to avoid surtaxes, but, nevertheless, there seems no doubt that this form of avoidance is still practiced to a large extent. By making partial distribution of profits and by showing some need for the accumulation of the remaining profits, the taxpayer makes it difficult to prove a purpose to avoid taxes.

"Your committee, therefore, recommends that the present section 104 be divided into two parts, one dealing with the personal holding company and the other with all other corporations which accumulate unreasonable surpluses. The part dealing with personal holding companies is new, while the present law has been retained with a few modifications to reach the other companies. (See secs. 102 and 103 of the bill.)"

S. Rept. No. 558, 73d Cong., 2d Sess., p. 15 (Mar. 28, 1934):

"The effect of this system is to provide for a tax which will be automatically levied upon the holding company without any necessity for proving a purpose of avoiding surtaxes. It is believed that the majority of these corporations are in fact formed for the sole purpose of avoiding the imposition of the surtax upon the stockholders."

The Senate Finance Committee agreed with the concern expressed by the House Ways and Means Committee, merely changing somewhat the provisions suggested by the House Committee. The Conference Committee adopted essentially the Senate provisions. Conf. Rept., H. Rept. No. 1385, 73d Cong., 2d Sess., pp. 1 (Amendment No. 45) and 7 (Amendment No. 124) (Apr. 30, 1934).

The Senate Finance Committee, in its report on the 1936 Revenue Act. (S. Rept. No. 2156, 74th Cong., 2d Sess., p. 23 (June 1, 1936)), described the 1934 Act personal holding company provisions as having proved "very effective in preventing accumulations in corporations to prevent the imposition of surtax on shareholders." In that Act, the Revenue Act of 1937, and the 1939 and 1954 Codes, the personal holding company tax provisions were retained with changes not substantially relevant in either purpose or effect to the instant case.

On the basis of this legislative history we agree in part with respondent's analysis of the controlling factors in Rev. Rul. 58-556, *supra*—petitioner's memberships will be treated as stockholdings for personal holding company purposes if they include the right to share in petitioner's profits, either currently (as by distribution or diversion of profits) or ultimately (as on dissolution).

Although the question of what rights are sufficient to make these memberships stock is a matter of Federal tax law, the question of whether those rights exist is a matter of State law. See, e.g., *George W. S. Swenson*, 37 T.C. 124, 131 (1961), on appeal (C.A. 8), and cases cited therein; *Laura Mussaglia*, 33 T.C. 379, 383.

Petitioner's charter specifically forbids distributions of income to its members and makes no provision for dissolution, but reserves broad amendment rights. The Delaware statutory

provision [20] regarding charter amendments is quite broad and would be read into petitioner's charter even if the charter did not specifically include it. *Peters v. United States Mortgage Co.*, 13 Del. Ch. 11, 14, 114 Atl. 598, 600 (1921).

We agree with respondent's view that we must examine into all the rights exercisable by members as such in order to

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[20] Del. Code Ann. tit. 8, sec. 242(a) (1953):

Sec. 242. Amendment of certificate of incorporation after payment of capital or where corporation has no capital stock

(a) Any corporation of this State existing prior to the tenth day of March, 1899, whether created by special act or general law, or any corporation created under the provisions of this chapter, may, from time to time, when and as desired, amend its certificate of incorporation by—

(1) Addition to its corporate powers and purposes, or diminution thereof, or both; or

(2) Substitution of other powers and purposes, in whole or in part, for those prescribed by its certificate of incorporation; or

(3) Increasing or decreasing its authorized capital stock or reclassifying the same, by changing the number, par value, designations, preferences, or relative, participating optional, or other special rights of the shares, or the qualifications, limitations or restrictions of such rights, or by changing shares with par value into shares without par value, or shares without par value into shares with par value either with or without increasing or decreasing the number of shares; or

(4) Changing its corporate title; or

(5) Making any other change or alteration in its certificate of incorporation that may be desired.

Any or all such changes or alterations may be effected by one certificate of amendment.

Every certificate of incorporation as so amended, changed or altered, shall contain only such provisions as it would be lawful and proper to insert in an original certificate of incorporation made at the time of making such amendment.

For our purposes, this provision is essentially a reenactment of Del. Rev. Code sec. 2058 (1935) (ch. 65, Corporations, sec. 26), in effect (with amendments not here relevant) during all the taxable years before the Court until the 1953 revision hereinabove set forth.

determine if we shall treat memberships as stock for this issue. We do not see why, if those rights include the right to amend, we should ignore the possible consequences of the exercise of that right—at least here, where the right to amend inheres solely to the members and does not involve the discretionary concurrence of others. Consequently, our inquiry is into whether petitioner's members may lawfully obtain for themselves petitioner's profits, either currently or ultimately, under petitioner's present charter or any amendments thereto which the members might lawfully make during the years before us on this question.

The privilege of incorporation without authorization of capital stock (Del. Code Ann. tit. 8, sec. 102(a)(4), (1953)[21]), is limited under applicable provisions of Delaware law to not-for-profit corporations. *Read v. Fidewater Coal Exchange*, 13 Del. Ch. 195, 116 Atl. 898 (1922); *Southerland v. Decinao Club*, 16 Del. Ch. 183, 142 Atl. 786 (1928). In *Read* (116 Atl. at 904), the chancellor described as follows the test of not-for-profit under the predecessor of the provisions set forth at footnote 21, herein:

Whether dividends are expected to be paid may, generally speaking, be taken as the test by which we are to determine

[21] The cited paragraph authorizes the issuance of classes of stock. It then provides that:

> The foregoing provisions of this paragraph shall not apply to corporations which are not organized for profit and which are not to have authority to issue capital stock. In the case of such corporations, the fact that they are not to have authority to issue capital stock shall be stated in the certificate of incorporation. * * *

For our purposes, this provision is essentially a reenactment of Del. Rev. Code (1935), section 2037(4) (Ch. 65, Corporations, section 5(4)), in effect (with amendments not here relevant) during all the taxable years before the Court until the 1953 revision hereinabove set forth.

whether, or not, a given corporation is organized for profit. Perhaps a better way to put it would be to say that a corporation is for profit when its purpose is, whether dividends are intended to be declared or not, to make a profit on the business it does which in reason belongs to it and which if its affairs are administered in good faith would be available for dividends. Subterfuges by which a corporation allowed its profits to be diverted to those owning it, though not in the form of dividends, would manifestly not remove from the corporation its feature of profit making. Nor would a mere declaration in its certificate of incorporation that it was organized not for profit, be sufficient to stamp upon it a nonprofit character. * * *

Profit furthermore must be something of a tangible or pecuniary nature. Intangible benefits not capable of measurement in definite terms, though of value to the recipients, cannot be called profits. When we speak of a corporation for profit, I take it also that we mean profit coming to, or belonging to, the corporation qua such, as distinct from its members or stockholders. Barring cases where profits are improperly diverted directly to the corporate members and not conveyed to them through the channel of the corporate treasury, which cases would rest on a distinct footing, the term "profit" as employed in the section under discussion means gain or earnings that are expected to come into the possession of the corporation.

The court held in *Read* that a corporation, whose existence as such had been attacked by one of its creditors, was truly not for profit and thereby entitled to exist as a nonstock corporation.

Decimo involved a bill in equity to revoke and forfeit a nonstock corporation's charter for abuse and misuse of corporate powers, privileges, and franchises. The defendant corpora-

tion's members had created a trust, beneficial interests in which were tied to membership in the corporation. The trust imposed membership dues, with which it purchased stock in a corporation created to engage in a pooled-purchasing scheme for profit. Dividends from the profit corporation went to the trust, which distributed them to the holders of its certificates of beneficial interest, a class of persons required to be identical with the class of members in the defendant nonstock corporation. Upon dissolution of the trust, its assets were to become the property of the defendant corporation. The chancellor characterized the arrangement as "a subterfuge by which the defendant, incorporated as a non-profit concern, seeks to accomplish as one of its chief purposes the end of earning pecuniary profits for its members, keeping control all the time over the operations of the venture and ultimately emerging in plain view as the absolute owner of the profit seeking enterprise." 142 Atl. at 792. The chancellor quoted with approval the *Read* definition of "organized for profit" set forth above, concluded that the defendant before him was so organized and operated, and granted the bill to revoke the corporation's charter.

We conclude that petitioner could not have incorporated as a nonstock corporation under Delaware law in effect during the period before the Court until the 1951 amendments discussed *infra*, at p. had the power to make profits for the pecuniary benefit of its members, either directly by way of distributions or indirectly by diversion of profits. The Delaware statute set forth at footnote 20, *supra*, forbids amendments which would not be "lawful and proper to insert in an original certificate of incorporation made at the time of making such amendment." Consequently, petitioner could not law-

fully distribute or divert profits to its members nor could it amend its charter to empower it to do so.

On the exemption issue (Issue 3, *supra*) respondent argued that Corporation's profits on the lock construction projects and the heaters distributed to Stevens' relatives and acquaintances were diversions of petitioner's income to or on behalf of members. Although respondent does not discuss this point with regard to the personal holding company issue, we think those contentions are relevant here. We have found, upon the basis of the record before us, that petitioner was fully compensated for its involvement in the lock construction projects. See *Stevens Brothers & Miller-Hutchinson Co.*, 24 T.C. 953 (1955). Stevens testified the heaters were distributed for experimental and therapeutic purposes and respondent did not challenge petitioner's proposed finding of fact to that effect. We have accepted this testimony of Stevens. *Blodgett v. Holden*, 275 U.S. 142, 146 (1927); *Woodworth v. Kales*, 26 F. 2d 178 (C.A. 6, 1928); *Saul M. Weingarten*, 38 T.C. 75, 79 (1962).

It follows from these facts, our view of Delaware law, and the presumption that actions are in compliance with the applicable law (see *Newlin Machinery Corporation*, 28 T.C. 837, 843-844 (1957); *Washington Post Co.*, 10 B.T.A. 1077, 1078-1080 (1928), and cases cited therein) that petitioner has not "allowed its profits to be diverted to those owning it." *Read v. Tidewater Coal Exchange*, 116 Atl. at 904.

Delaware law provides that, on liquidation of a corporation, after debts and expenses are paid, "The trustees or receivers of a dissolved corporation * * * shall distribute and pay [any balance remaining] to and among those who shall be justly entitled thereto, as having been stockholders of the

corporation, or their legal representatives." Del. Code Ann. tit. 8, sec. 281 (1953).[22] The *ratio decidendi* of *Read* and *Decimo* would require that the specific reference to "stock" in the liquidation provisions would forbid distribution of accumulated profits to members of a nonprofit, nonstock corporation on liquidation. Especially in the light of the expressed reluctance of the Delaware courts to read qualifying language into statutes (*Maddock v. Vorclone Corporation*, 17 Del. Ch. 39, 42, 147 Atl. 255, 256 (1929)), we conclude that petitioner's members would not be permitted to share in petitioner's profits on liquidation.[23]

However, in 1951 the Delaware Legislature amended the Revised Code of 1935 to permit consolidations or mergers

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[22] For our purposes, this provision is essentially a reenactment of Del. Rev. Code (1935), sec. 2077 (ch. 65, Corporations, sec. 45), in effect during all the taxable years before the Court until the 1953 revision hereinabove set forth.

[23] It may be that this reasoning would not bar distribution of surplus to the extent of each individual member's contributions to petitioner. While that may be relevant in determining whether petitioner is taxable, it appears to be of no moment for personal holding company purposes, since the latter provisions are concerned with forcing distributions of profits and not of capital.

between stock companies and nonstock companies.[24] This amendment applies to nonstock corporations "whether organized for profit or not organized for profit." It authorizes conversion of membership interests into "interests of value" in the resulting corporation.

[24] 48 Del. Laws, ch. 352, sec. 1 (approved June 15, 1951); added a new section, 2091D, to the Del. Rev. Code of 1935 (ch. 65, Corporations, sec. 59D), to read as follows:

"2091D. Sec. 59D. CONSOLIDATION OR MERGER OF NON-STOCK CORPORATIONS. ORGANIZED FOR PROFIT OR NOT FOR PROFIT, WITH STOCK CORPORATIONS; PROCEEDINGS FOR:—Any one or more non-stock corporations, whether organized for profit or not organized for profit, organized under the provisions of this Chapter, or existing under the laws of this State, may consolidate or merge with one or more stock corporations, whether organized for profit or not organized for profit, organized under the provisions of this Chapter, or existing under the laws of this State, into a single corporation * * *. [T]he directors, or a majority of them, of such stock corporations as desire to consolidate or merge and the members of the governing body, however called, or a majority of them, of such non-stock corporations as desire to consolidate or merge may enter into an agreement * * * stating * * * the manner of converting the shares of stock of a stock corporation and the interests of members of a non-stock corporation into shares or other securities of the corporation resulting from or surviving such consolidation or merger or of converting the shares of stockholders in a stock corporation and the interests of members of a non-stock corporation into membership interests of the non-stock corporation resulting from or surviving such consolidation or merger, as the case may be, with such other details and provisions as are deemed necessary; provided, however, that in such consolidation or merger the interests of members of a constituent non-stock corporation may be treated in various ways so as to convert such interests into interests of value, other than shares of stock, in the proposed new or resulting stock corporation or into shares of stock in the proposed new or resulting stock corporation, voting or non-voting, or into creditor interests or any other interests of value equivalent to their membership interests in their non-stock corporation, * * *."

These provisions were substantially reenacted as Del. Code Ann. tit. 8, secs. 257, 258 (1953).

Another section of the same amending act provided for the first time for valuation of and payment for memberships of dissenting members in the event of consolidations or mergers.[25]

The 1951 amendments here discussed contrast sharply with the 1941 amendment permitting consolidations or mergers of nonstock corporations.[26] That amendment, by its terms, applied only to "nonstock, nonprofit corporations." Although the provision regarding valuation of stock of dissenting stockholders in consolidations or mergers was amended by another section of the same 1941 Act (sec. 16), no effort was there made to authorize payment for the value of memberships.

We have not found any judicial decision construing these statutes insofar as they apply to nonstock corporations, nor have any such decisions been brought to our attention.

Despite the fact that the predecessors of Del. Code Ann. tit. 8, secs. 102(a)(4), 242(a), and 281, set forth *supra*, were not amended by this 1951 Act, we conclude that the Delaware Legislature intended to and did change the law to give to members in nonstock corporations the right to share in the current or accumulated profits of those corporations. See *Commissioner v. Bilder*, 369 U.S. 499 (1962).

Petitioner argues that the powers of amendment so reserved cannot be exercised to change a corporation in such a manner as to make it an entirely different kind of a corporation or to change substantially its objects and purposes. It

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[25] 48 Del. Laws, ch. 352, sec. 4, amending Del. Rev. Code of 1935, sec. 2093 (ch. 65, Corporations, sec. 61). This provision was substantially reenacted as Del. Code Ann. tit. 8, sec. 262(a) (1953).

[26] 43 Del. Laws, ch. 132, sec. 14, Del. Rev. Code, sec. 2091C (1935), (ch. 65, Corporations, sec. 59C) (approved Apr. 9, 1941), substantially reenacted as Del. Code Ann. tit. 8, secs. 255, 256 (1953).

cites 7 Fletcher, Cyclopedia of the Law of Private Corporations, sec. 3718, p. 886; *Palez v. Delaware Polish Beneficial Ass'n.*, etc., 29 Del. Ch. 87, 169 Atl. 595 (1933); 13 Am. Jur., Corporations, sec. 86, p. 230; *Midland Co-operative W. v. Range Co-operative O. Ass'n*, 200 Minn. 538, 274 N.W. 624 (1937), 111 A.L.R. 1521 and annot., 1525; *Imperial Trust Co. v. Magazine Repeating Razor Co.*, 138 N.J. Eq. 20, 46 A. 2d 749 (1946). The cited Delaware case, decided before the 1951 amendments discussed above, merely reserves the question,[27] and the other cases and materials relied upon are distinguishable because of the different and more restrictive statutory provisions involved.

We are reluctant to rule on matters of State law where the courts of that State have not spoken directly. Nevertheless, we are here required to determine what Delaware law was during the taxable years before us. In light of the cited statutory provisions and the few relevant cases we have found we conclude that the courts of Delaware would have decided the questions of State law in the manner hereinabove set forth had they been faced with those questions.

Accordingly, we hold petitioner's memberships do not, for the taxable year 1948, and do, for the taxable years 1952 through 1958 constitute "stock" for purposes of the personal holding company provisions of the 1939 and 1954 Internal Revenue Codes.

Petitioner's third argument applies only to the taxable year 1955. As to that year, it maintains that less than 80 percent of its gross income was personal holding company income within the meaning of section 543 of the 1954 Code.

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[27] The same question is also reserved in **Davis v. Louisville Gas & Electric Co.**, 16 Del. Ch. 157, 160, 142 Atl. 654, 655 (1928).

Under section 7701(a)(2) of the 1954 Code [28] petitioner's relationship with Corporation regarding the construction projects is treated as a partnership and petitioner is treated as a partner. Under section 702(b) of the 1954 Code [29] petitioner's share of the Cheatham Lock project profit retains the same character to petitioner as it had to the joint venture.

The income received by petitioner from its joint venture with Corporation relating to the sale of sheet steel piling and equipment used in the Cheatham Lock project was income received from the sale of property. The property was not stock or securities. Sec. 543(a)(2), 1954 Code. The income was not of the sort includable within any of the categories of personal holding company income listed in the statute.

Although petitioner's disagreement with respondent as to the character for personal holding company purposes of the gain on the above-discussed sales was manifested to respond

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[28] SEC. 7701. DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

* * * * * * *

(2) Partnership and partner.—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

[29] SEC. 702. INCOME AND CREDITS OF PARTNER.

(b) Character of Items Constituting Distributive Share.—The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (8) of such section (a) shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

ent before the trial and on brief, we have been given little light on respondent's view of the issue regarding petitioner's taxable year 1955.

Respondent determined petitioner was a personal holding company for its taxable year 1955 but he did not determine that petitioner's profit from the Cheatham Lock project in that year fell into any particular category of personal holding company income. See sec. 543(a) 1954 Code. Aside from his suggestions in Issues 3 and 8 that petitioner's investments in the lock construction projects were loans from which petitioner derived interest income, which argument we reject, respondent nowhere suggests this income falls into any of the listed categories, nor has he even stated the general proposition that it constitutes personal holding company income.[30]

Our examination of petitioner's return for its taxable year 1955 and the partnership return it filed with Corporation for calendar 1954 convinces us that less than 80 percent of petitioner's gross income for its taxable year 1955 was personal holding company income.

On this issue we hold for petitioner as to its taxable years 1948 and 1955 and for respondent as to each of petitioner's taxable years 1952 through 1954 and 1956 through 1958.

Issue 5. Worthless Securities

Respondent maintains petitioner has not shown that the Denver & Rio Grande and St. Louis & San Francisco securities claimed by it to have become worthless in petitioner's

[30] On brief respondent asserted petitioner conceded that the 80-percent requirement had been met for all the taxable years before the Court on this issue. On reply brief respondent conceded that this assertion was incorrect as to the taxable year 1955.

taxable year 1949 in fact became worthless in that year or any year before the Court. Respondent does not dispute petitioner's claimed basis in the stock.

Petitioner relies on the testimony of its president that the stock became worthless in 1949 and was therefore deductible in its taxable year 1949.[31] Petitioner argues in the alternative that, since part of the stock was purchased on the day before the start of the first year before the Court and the remaining stock purchased during that first year, and since the stock was worthless at the time of the trial, it must have become worthless during one of the years before the Court. It would be improper, petitioner maintains, to deny the deduction for all the 11 years before the Court in this proceeding merely because petitioner is unable to establish to which particular year the loss is attributable. Petitioner offers to permit respondent to choose the year of deduction.

Whatever the merits of petitioner's equitable-legal argument, we are not impressed with its factual underpinnings. Petitioner's president testified he attempted to sell the stock in 1949 and was unable to do so. We are not told what was the nature of the attempt. At what price did he offer it? Did he advertise the offer and, if so, where? See *West End Pottery Co.*, 7 B.T.A. 927, 929 (1927). Petitioner's president testified

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[31] SEC. 23. [1939 Code] DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * * *

(g) Capital Losses.—

* * * * * * *

(2) Securities becoming worthless.—If any securities (as defined in paragraph (3) of this subsection) become worthless during the taxable year and are capital assets, the loss resulting therefrom shall, for the purposes of this chapter, be considered as a loss from the sale or exchange, on the last day of such taxable year, of capital assets.

as to his belief that the stock became worthless in 1949 and that it was worthless at the time of the trial. However, this type of testimony is of little value in fixing the fact or time of worthlessness. *Boehm v. Commissioner*, 326 U.S. 287, 292-293 (1945).

We note that petitioner purchased Denver & Rio Grande bonds late in 1947, the same year it purchased the stock. In 1951 petitioner was able to sell those bonds for approximately 2½ times their purchase price. Although this is not conclusive evidence that the stock had a value in 1949, nevertheless it suggests the stock probably was not worthless. See *Helvering v. Taylor*, 293 U.S. 507 (1935).

Petitioner has failed to sustain its burden of proving the stock became worthless during the period before the Court and we therefore need not reach the question of the year in which the loss would be deductible.

On this issue we hold for respondent.

Issue 6. Interest

Respondent disallowed $5,308.33 of the $24,508.33 interest expense petitioner claimed on the Form 990 it filed for its taxable year 1950. In his deficiency notice and counsel's opening statement, respondent assigned no reason for the disallowance. On brief, respondent notes the testimony of petitioner's president that petitioner's officers determined the amount was paid in error and that they had contributed a fund out of which petitioner would be reimbursed for erroneous payments of that nature.

Petitioner maintains the entire amount was paid, that it was interest expense, that it was not unreasonable in amount, and that reimbursement was not made during that taxable year.

We agree with petitioner.

Petitioner's president testified as to each item of petitioner's argument noted above and this testimony was undisputed by respondent.

Respondent does not suggest the transaction was sham nor does he attempt to assert his reallocation powers under section 45 of the 1939 Code. Under these circumstances we hold petitioner has met its burden of demonstrating its entitlement to the deduction of the entire $24,508.33 interest expense for the taxable year 1950.

We note that under the law in effect during that taxable year and since, such reimbursements, when made, will constitute income to petitioner to the extent they are reimbursements of expenditures taken as deductions which reduced petitioner's tax for its taxable year 1950. Secs. 22(b)(12)(D), 1939 Code, and 111(a)(4), 1954 Code. See Rev. Rul. 58-546, 1958-2 C.B. 143, 144. Even if petitioner had been repaid after the end of its taxable year 1950, its 1950 deductions would not be affected by this repayment. *A fortiori*, since petitioner, a cash basis taxpayer, had not been repaid even as late as the trial in this proceeding its 1950 deductions should not be affected by a mere hope or expectation of repayment.

On this issue we hold for petitioner.

Issue 7. Algiers Lock Income

Respondent does not explain his reallocation among petitioner's taxable years 1949, 1950, and 1951 of petitioner's income from its Algiers Lock investment except to note that it is consistent with the partnership returns filed by petitioner and Corporation for the relevant calendar years.

Petitioner concedes that if its relationship with the company is taxable as a partnership, then because of section 188

of the 1939 Code,[32] its income for those years should be allocated as respondent has determined. Apparently, petitioner itself contends that the relationship was a partnership but assigned error to respondent's determination on this issue because of respondent's alleged inconsistency between his treatment of those years and his treatment of petitioner's taxable years 1954 and 1955.

We have found this relationship to be a joint venture, taxable as a partnership (sec. 3797 (a) (2), 1939 Code),[33] and accordingly hold for respondent on this issue.

Issue 8. Cheatham Lock Income

The calendar 1954 partnership return filed by petitioner and Corporation reported income from the Cheatham Lock project on a completed contract basis. The sale of steel sheet piling and equipment was reported as producing long-term capital gain. This capital gain item was then reported as such on petitioner's return for its taxable year 1955.

Respondent determined that this gain is ordinary income. His position is that these items were not capital assets under section 1221 of the 1954 Code. He argues that ownership in the steel sheet piling was transferred to the Corps of Engineers and returned to the joint venture only when the piling

[32] SEC. 188. DIFFERENT TAXABLE YEARS OF PARTNER AND PARTNERSHIP.

If the taxable year of a partner is different from that of the partnership, the inclusions with respect to the net income of the partnership, in computing the net income of the partner for his taxable year, shall be based upon the net income of the partnership for any taxable year of the partnership (whether beginning on, before, or after January 1, 1939) ending within or with the taxable year of the partner.

[33] This provision, amended by sec. 340(a), Revenue Act of 1951, was reenacted as sec. 7701(a)(2), 1954 Code, set forth at footnote 28, *supra*.

was pulled from the job. At that point the piling was no longer used on the job but was merely held for sale to customers. It was therefore not a capital asset. Furthermore, neither the steel sheet piling nor the equipment was held by petitioner since, by the terms of its agreement with Corporation, it did not own any of the property used in the construction project. Alternatively, respondent maintains that neither the steel sheet piling nor the equipment was held more than 6 months. Alternatively, respondent maintains that petitioner's net income from the Cheatham Lock project was interest income.

On reply brief, petitioner concedes that the property did not constitute capital assets under section 1221 but maintains the property was used in its trade or business within the meaning of section 1231 (a); that it was subject to depreciation; and that it was held for more than 6 months. As to the steel sheet piling, petitioner maintains that it was not transferred to the Corps of Engineers at any time.

We agree with respondent's conclusion that petitioner's profit on the sale of these items is taxable as ordinary income and not as capital gain.

An essential part of the definition of "property used in the trade or business" within the meaning of the provision petitioner relies upon[*] is that it is subject to an allowance for depreciation.

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[*] SEC. 1231. [1954 Code] PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS.

(b) Definition of Property Used in the Trade or Business.—For purposes of this section—

(1) General rule.—The term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 6 months,

Stevens testified as to the equipment and stated that it had been depreciated and that, up to the time of the trial, the Internal Revenue Service had not questioned the decision to depreciate this property.

The schedule attached to the partnership return petitioner filed with Corporation for calendar 1954 does not sufficiently indicate the nature of the equipment to permit us to determine whether it is depreciable. We note an explanation on the schedule indicating that the profit from the sale of that equipment equaled its sales price less the commission paid on the sale, suggesting that the entire cost of the equipment had been used to offset ordinary income either as depreciation or as cost of materials. Another schedule on that return indicates that details of the depreciation are to be found on Corporation's tax return. Corporation's return was not submitted into evidence. Stevens' testimony as to the legal conclusion of depreciability does not fill the gap. Petitioner has failed to sustain its burden of proof.[25]

Since the completed-contract method of accounting for profits on the Cheatham Lock construction project was used in the partnership return, all income and expense items for the entire project were taken in one year. If the profits are treated in entirety as ordinary income, as respondent here proposes, it makes no difference if one part is reduced by depreciation and another part increased in the same amount by virtue of a reduction in basis. Consequently, we do not infer that respondent allowed for depreciation on this equip-

[25] Since petitioner first relied upon section 1231 of the 1954 Code on reply brief, we do not interpret respondent's silence on the depreciation issue as implicit acquiescence in petitioner's view of the facts. Cf. **Blodgett v. Holden**, 275 U.S. 142; **Woodworth v. Kales**, 26 F. 2d 178; **Saul M. Weingarten**, 38 T.C. 75.

ment from the fact that respondent neglected to go through the motions of changing all of the different items that would have to be changed if he were to disallow the depreciation.

Another essential part of the definition of "property used in the trade or business" within the meaning of section 1231, *supra*, is that the property has been held for more than 6 months.

Stevens testified as follows regarding the steel sheet pilings:

Q. Did the contractors transfer ownership of that piling to the corps of engineers?

A. Only for the time that was required on the lock, a rather indefinite time. We couldn't dispose of it.

Q. You couldn't, you say you couldn't dispose of it?

A. As long as we needed it on this job.

Q. Did you transfer ownership of it to the corps?

A. That I couldn't answer.

This testimony raises substantial doubts as to whether the joint venture held the steel sheet pilings more than 6 months. On brief, petitioner maintains this property was never transferred to the Corps of Engineers. Petitioner's counsel seeks to attack Stevens' testimony as being "consistent with Mr. Stevens age and his observable limitation of hearing." However, the possibility of transfer to the Corps of Engineers was raised by petitioner's counsel at the hearing and not by Stevens. We do not find in the record evidence convincing us that it would be unjust to bind petitioner to the testimony of its own witness, who is also its president.

Petitioner makes much of the fact that respondent failed to submit the Corps of Engineers' copy of the Cheatham Lock contract, for which submission the record was kept open after the trial. However, in the absence of a showing

that the contract was unavailable to petitioner, and in the light of the fact that petitioner wishes to use the contract to contradict a part of the testimony of its own witness, we decline to read this failure to submit the contract as an admission on the part of respondent that the sheet steel pilings had never been transferred to the Corps of Engineers. On the record that the parties have made in this case we must conclude that they were transferred to the Corps of Engineers. We have no information as to when the pilings were transferred back to the joint venture or any of the joint venturers and so we must conclude that petitioner has failed to sustain its burden of proving that it or the joint venture held the steel sheet pilings for more than 6 months.

Petitioner has failed to meet its burden of proving that the sale of either category of property involved in this issue gave rise to capital gains.

In petitioner's reply brief it is stated that Corporation's share of profits from the sales here at issue was "treated by respondent as gain from the sale of depreciable assets as provided by Sec. 117 (j) of the 1939 Code and Sec. 1231 (a) of the 1954 Code." Since no offer was made to submit evidence regarding respondent's treatment of Corporation's share of this income we decline to consider what effect such evidence, it submitted, would have on this proceeding.

On this issue we hold for respondent.

Issue 9. Failure to File Returns

Respondent maintains petitioner failed to sustain its burden of proving that its failure to file income tax returns for its taxable years 1948 through 1954 and personal holding company tax returns for its taxable years 1948, 1952, 1953, and 1954 was due to reasonable cause and not to willful

neglect. Respondent concludes that petitioner is liable under section 291 (a) of the 1939 Code[36] for additions to tax in the amount of 25 percent for each of those years.

Petitioner relies on its exemption certificate, which specifically stated it need file only information returns for those years. Petitioner maintains that this, together with advice of an attorney obtained after respondent revoked the certificate, are sufficient to constitute reasonable cause for failure to file. Petitioner does not argue on this issue that the information returns it filed satisfied its obligation to file returns for those years. Cf. *Germantown Trust Co. v. Commissioner*, 309 U.S. 304 (1940); *McKinley Corporation of Ohio*, 36 T.C. 1182 (1961).

We agree with respondent for all the years and all the returns before us on this issue except the personal holding company tax return for petitioner's taxable year 1948. The addition to tax for that return falls, in consequence of our determination (Issue 4, *supra*) that petitioner was not a personal holding company for that year. *Sebago Lumber Co.*, 26 T.C. 1070 (1956).

Ignorance of the law's requirements does not constitute a reasonable cause for failure to fulfill those requirements here, failure to file a timely return. *West Side Tennis Club*, 39 B.T.A. 149 (1939), aff'd. 111 F. 2d 6 (C.A. 2, 1940). On

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[36] SEC. 291. FAILURE TO FILE RETURN.

(a) In case of any failure to make and file return required by this chapter, within the time prescribed by law or prescribed by the Commissioner in pursuance of law, unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the tax: 5 per centum if the failure is for not more than thirty days with an additional 5 per centum for each additional thirty days or fraction thereof during which such failure continues, not exceeding 25 per centum in the aggregate. * * *

the other hand, it is accepted that good faith reliance on the advice of competent tax counsel that a return need not be filed, where such advice was timely sought and was based on full knowledge of the relevant facts, does constitute reasonable cause for failure to file a return. *C. R. Lindback Foundation*, 4 T.C. 652, 667 (1945), affd. 150 F. 2d 986 (C.A. 3, 1945). A *fortiori*, one is entitled to rely on an exemption certificate issued by respondent; provided respondent is not misinformed as to the facts.

However, an acceptable reason for failure to file a return will excuse such failure only so long as the reason remains valid. On August 24, 1954, respondent revoked petitioner's certificate of exemption. From that point on, the revoked exemption certificate could no longer constitute reasonable cause for failure to file returns for the years prior to 1954.

Nothing in this record shows that Stevens' efforts to determine the reasons for the revocation, his consultations with private attorneys (we are not told when they occurred), or his conference with respondent's employee, Oberg (conference held in 1960), elicited the advice that returns should not be filed.[37] We note that petitioner did file timely returns for each of its next 4 taxable years, each with a protest noted prominently on its first page, disclaiming any implied waiver of petitioner's position as to tax exemption.

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[37] Stevens' testimony regarding his conference with his attorney is not sufficient to persuade us that the attorney advised Stevens that despite the revocation petitioner should not file returns for the earlier years. See, *e.g.*, **John Balestreri**, 47 B.T.A. 241, 243 (1942). See also **Coates v. Commissioner**, 234 F. 2d 459 (C.A. 8, 1956), affirming an unreported Memorandum opinion of this Court. The Court of Appeals there affirmed our decision that when a taxpayer submitted his books and records to his accountant, upon whom he had relied for the tax advice for 15 years, and the accountant failed to specifically advise him not to file a declaration of estimated tax, that his failure to file a timely declaration was not due to reasonable cause.

In view of the general nature of the obligation of filing returns and the specific admonishment by the Commissioner's subordinates that petitioner should file returns for the specified years it is not too much to expect that "ordinary business care and prudence" (*Charles E. Pearsall & Son*, 29 B.T.A. 747, 749 (1934); Regs. 111, sec. 29.291–1; Regs. 118, sec. 39.291–1 (b)) would require petitioner to secure expert advice specifically on this point before ignoring the Commissioner's justifiable directions. The evidence fails to show petitioner obtained any advice regarding the filing of returns for the years before us on this issue.

We conclude that petitioner has failed to show that its failure to file the returns required of it for its taxable years 1948 through 1954 was due to reasonable cause and not to willful neglect.

Petitioner cites to us *Economy Savings & Loan Co. v. Commissioner*, 158 F. 2d 472 (C.A. 6, 1946), reversing in part 5 T.C. 543 (1945); *Palm Beach Trust Co. v. Commissioner*, 174 F. 2d 527 (C.A.D.C. 1949), reversing in part 9 T.C. 1060 (1947); *E. D. Gensinger*, 18 T.C. 122 (1952), reversed on other issues 208 F. 2d 576 (C.A. 9, 1953); *Stockstrom v. Commissioner*, 190 F. 2d 283 (C.A.D.C. 1951), reversing 14 T.C. 652 (1950); and *United States v. Eversman*, 133 F. 2d 261 (C.A. 6, 1943).

The filing of a return in the circumstances before us on this issue is not the "fruitless ritualistic measure" condemned in *Eversman*, for it is specifically commanded by statute, disregard of which results in imposition of a substantial penalty and it serves a significant purpose in the system of income taxation devised by the Congress. Nor are we faced with the *Stockstrom* situation in which a responsible Government official, with full knowledge of the facts, advised

a taxpayer that he was not liable for the tax. Nor has respondent here followed in the footsteps of petitioners error, as did the Commissioner in *Gensinger*, where a deficiency notice was first issued for the short taxable year for which the taxpayer had improperly filed a return.

In *Economy Savings* and *Palm Beach* the taxpayers introduced no evidence regarding the nature of their reasons for failure to file the returns in question but merely relied on the reasonableness of their belief that they were not liable for the tax. In each case the appellate court agreed with our view that the taxpayers were liable for the tax but reversed our determination that the taxpayer was liable for the additions to tax for failure to file returns.

The Circuit Court of Appeals in *Economy Savings* felt that the taxpayer's real belief that no excess profits tax returns was required was based upon reasonable grounds. The Court of Appeals in *Palm Beach* merely stated in its per curiam opinion that "there was a question debatable in good faith" concerning the taxpayer's liability for the personal holding company surtax. Apparently those courts' view of what constitutes a question "debatable in good faith" does not depend upon the closeness of the division of judicial opinion, for both appellate courts were unanimous in affirming this Court's view as to the debatable question—whether those taxpayers were liable for the taxes. Both cases had been reviewed by the full Tax Court and there were no dissents in *Economy Savings* and only one in *Palm Beach* on the question of tax liability. From this record we conclude the rule of those cases to be that any real, nonfrivolous dispute concerning liability for a particular tax constitutes reasonable cause for failure to file the appropriate return.

regardless of whether the taxpayer can show that competent, fully informed tax counsel advised him not to file the return.

With this rule we cannot agree.

Since the Congress has not defined "reasonable cause" in the statute, we must examine the legislative history of that provision and give that content to the words that would best serve what we gather to have been Congress' purpose in enacting the provision. We find no indication in the committee reports regarding this matter and so we turn to the predecessors of this provision.

Although the history of the failure to file addition[38] shows a congressional trend toward decreasing severity between 1909 and 1936, nevertheless the substantial size of the addition to tax and the fact that the trend halted between 1936 and the years before the Court on this issue suggest Congress took a dim view of failure to file a return. This is understandable, for, as Mr. Justice Jackson speaking for a unanimous Supreme Court noted with regard to income tax and personal holding company tax returns, the requirement of timely filing on appropriate returns "implements the system of self-assessment which is so largely the basis of our American scheme of income taxation. The purpose is not alone to get tax information in some form but also to get it with such uniformity, completeness, and arrangement that the physical task of handling and verifying rates may be readily accomplished." *Commissioner v. Lane-Wells Co.*, 321 U.S. 219, 223 (1944).

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[38] The amount of the addition was reduced from 50 percent (sec. 38 (Fifth), Revenue Act of August 5, 1909) to 25 percent (sec. 1317, Revenue Act of 1918), to 5 percent per 30 days or part thereof up to a maximum of 25 percent (sec. 406, Revenue Act of 1935); reasonable cause was extended from an excuse merely for tardy filing to an excuse for complete failure to file (sec. 291, Revenue Act of 1936).

Much room may be found for disagreement as to the proper treatment of items on one's tax returns. Elaborate mechanisms have been devised to assure the taxpayer of opportunity to contest the actions of the tax collector. Petitioner's presence in this proceeding is proof that the taxpayer is entitled to a judicial decision before he may be compelled to pay the tax allegedly due from him.

However, our income tax system depends in the first instance on disclosure by the taxpayer, on forms prescribed and furnished for the purpose by the Commissioner according to law, of the information upon which a tax liability may be based. The history of our Code provisions indicates the great concern of the Congress that the Commissioner be informed annually of the elements of the taxpayer's taxable income. So it is, for example, that an assessment may normally be made only within 3 years after the filing of a return (sec 275 (a), 1939 Code) but it may be made at any time if no return has been filed. Sec. 276 (a), 1939 Code. The longer statute of limitations applicable when a taxpayer omits from gross income an amount properly includable therein which exceeds 25 percent of the gross income reported (sec. 275 (c), 1939 Code) may be avoided if the taxpayer notes with sufficient detail the information regarding the omitted item on the return, even though he fails to include it in income. *Colony, Inc. v. Commissioner*, 357 U.S. 28 (1958); *Sluff v. Commissioner*, 220 F. 2d 65 (C.A. 9, 1955).

We have many times asserted the view that the taxpayer's belief (and the belief of the appropriate fiduciary, officer, or agent of a non-individual taxpayer) that it is not liable for a tax is not sufficient to constitute reasonable cause for failure to file a return. See, e.g., *West Side Tennis Club, supra*. Even when the taxpayer shows that he relied upon

advice that a return need not be filed, we have upheld imposition of the failure to file addition in the absence of a showing that the advice itself was timely sought (e.g., *Estate of Charles Curie*, 4 T.C. 1175, 1185 (1945)) and that it was given by a competent tax adviser (e.g., *Herman Co.*, 11 T.C. 442 (1948), affd. 175 F. 2d 776 (C.A. 3, 1949)) fully informed as to the facts of the case. E.g., *Giros v. Commissioner* 238 F. 2d 579 (C.A. 8, 1956), affirming a Memorandum Opinion of this Court.

We have found very few cases in which the Court's opinion indicates the argument had been made as plainly as that apparently accepted by the appellate courts in *Palm Beach* and *Economy Savings*—failure to file a return is due to reasonable cause where there is a "question debatable in good faith" as to the liability of the taxpayer for the tax. This argument was rejected in *Fides, A. G. v. Commissioner*, 137 F. 2d 731, 735 (C.A. 4, 1943), affirming 47 B.T.A. 280 (1942); *Southeastern Finance Co.*, 4 T.C. 1069, 1087 (1945), affd. 153 F. 2d 205 (C.A. 5, 1946); *A. C. Monk & Co.*, 10 T.C. 77, 83 (1948); *Elizabeth Lewis Saigh*, 36 T.C. 395, 430 (1961).

The "reasonable argument" or "question debatable in good faith" doctrine seems to us to be inconsistent with the test generally imposed regarding advice of counsel. If a taxpayer has a reasonable (though unsuccessful) argument as to liabilty, why should it matter, under the view expressed by the appellate courts in *Palm Beach* and *Economy Savings*, whether this argument was suggested to the taxpayer by qualified counsel. Yet this Court is in the mainstream of judicial approach when it inquires into the source of the taxpayer's advice in determining the existence of reasonable cause. E.g., *West Side Tennis Club*, 39 B.T.A. 149 (1939) affd. 111 F. 2d 6 (C.A. 2, 1940) (Did the taxpayer's efforts

to maximize income from Davis Cup matches cause it to lose its exemption?); *Genevra Heman*, 32 T.C. 479 (1959), affd. 283 F. 2d 227 (C.A. 8, 1960) (Was redemption of stock in exchange for cancellation of a debt, concededly for a bona fide business purpose, essentially equivalent to a dividend?); *Abraham J. Muste*, 35 T.C. 913 (1961) (Was it constitutional to impose an income tax on a taxpayer whose religious views forbade him to support war, if such tax went to pay for armaments or other war expenses?); *Eleanor C. Shomaker*, 38 T.C. 192 (1962), on appeal (C.A. 8, Sept. 10, 1962) (Was that part of alimony payments intended for the support of minor children taxable to the mother where the decree did not fix, in terms, the amounts so allocable? The return was filed late, but more than 1 year before the Supreme Court's decision in *Commissioner v. Lester*, 366 U.S. 299 (1961).) In each of those cases the addition was imposed, despite the taxpayer's reasonable argument on the issue of tax liability, because of the taxpayer's failure to show timely reliance on the advice of competent, informed tax counsel that no return was required.

The language of this Court in *Southern Maryland Agricultural Fair Association*, *supra* at 553-554, involved the pre-1936 additions to tax provisions but is nevertheless applicable here:

> Although this petitioner was encouraged by the action of the Commissioner to believe that it would not have to file returns for 1923 and subsequent years, nevertheless, it was never prevented from filing returns. It could have filed returns and might thereby have started the period of limitations, though still claiming exemption. Some taxpayers take such precautionary steps. There is no inequity in requir-

ing this petitioner to pay the taxes actually imposed upon it by the revenue acts. It could have avoided the inequity of the penalties by filing returns promptly after it learned of the correctness of the ruling in 1937, but it chose not to file any returns for the years here involved, apparently hoping thereby to avoid both tax and penalty. Having made the choice, it must abide by it and take the consequences.

We adhere to our position, as applied to the facts of this case, that petitioner's arguments on the issues of tax exemption and personal holding company are not sufficient to constitute reasonable cause for failure to fulfill the statutory requirements of filing income tax returns for the taxable years 1948 through 1954 and personal holding company tax returns for its taxable years 1952 through 1954.

We have held that petitioner was not a personal holding company for the taxable year 1948. It therefore was not obliged to file a personal holding company return for that year. Since the failure to file in the case of each of the other returns required to be filed for the taxable years before us on this issue extended for more than 4 months, imposition of the maximum 25-percent addition in the case of each of those returns is sustained. Except for adjustments in amount occasioned by adjustments in petitioner's taxable income, our decision as to the personal holding company issues for petitioner's taxable year 1948, and respondent's concession as to additions to tax for the taxable years 1955 through 1958, all of which will be given effect in the Rule 50 computation, we find for respondent on this issue.

Decision will be entered under Rule 50.

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 17,332

Stevens Bros. Foundation, Inc., Petitioner, v. Commissioner of Internal Revenue, Respondent.	On Petition for Review of the Decision of the Tax Court of the United States.

[November 15, 1963.]

Before Sanborn and Matthes, Circuit Judges, and Robinson, District Judge.

Matthes, Circuit Judge.

This case is before us on petition to review a decision of the Tax Court which sustained, to a large extent, the Commissioner's assessment of deficiencies in corporate income and personal holding company taxes, and penalties, against Stevens Bros. Foundation, Inc. (Foundation). The questions on review are whether the Tax Court erred in holding that

(1) Foundation had—

(a) not been operated exclusively for charitable purposes during its taxable years 1948 through 1955;

(b) unreasonably accumulated income during its taxable years 1952 through 1958;

and therefore that Foundation was not exempt from taxation as a charitable organization during its taxable years 1948 through 1958.

(2) The Commissioner did not abuse his discretion in *retroactively* revoking a 1947 ruling exempting Foundation from taxation as a charitable organization.

(3) Foundation was a personal holding company for the taxable years 1952 through 1954, and 1956 through 1958.

(4) Foundation was subject to additions to tax for failure to file corporation income tax returns for its taxable years 1948 through 1954, and for failure to file personal holding company tax returns for its taxable years 1952, 1953, and 1954.

(5) Foundation failed to prove that it incurred capital losses of $9,849.40 due to the worthlessness of certain securities it held.

(6) Foundation received ordinary income of $25,778.24 from the Cheatham Lock project in 1955, rather than a long-term capital gain of $48,306.44 and an ordinary loss of $22,528.20.

The basic facts, in the main stipulated and undisputed, are set forth at length in the Tax Court's opinion, 39 T.C. 11 (1962). Certain background features of this controversy are stated in *Stevens Brothers & Miller-Hutchinson Co. v. Commissioner*, 24 T.C. 953 (1955). Rather than reiterate the facts in detail, we need only restate those necessary to highlight the nature of the issues now before us.

Foundation was incorporated under the laws of Delaware on December 31, 1942, by Edward Fenton Stevens (Stevens), his wife, and two of his brothers, and maintains its principal office in St. Paul, Minnesota. Six other persons

related to Stevens either by blood or marriage—were subsequently admitted to membership in Foundation.

In 1943, Foundation applied for exemption from federal income taxes as a charitable corporation, and by letter of May 1, 1947, was granted exempt status by the Commissioner, subject to redetermination if Foundation should change its character or purpose or its method of operation. There is no doubt that Foundation was *organized* for charitable purposes and that its charter so provided.

The four founders of Foundation were also partners in Stevens Bros. Contractors (Partnership), and shared equally in Partnership's profits until the death of one partner in 1955; thereafter, the remaining three persons shared equally. During the years here involved, Partnership owned two-thirds of the stock of a construction company known as Stevens Bros & Miller-Hutchinson Company, Inc. (Corporation). Stevens was president of Corporation and R. C. Hutchinson—who had no interest in Foundation or Partnership—was its secretary-treasurer.

In 1947, Hutchinson, who was then in active charge of Corporation, consulted with Stevens about bidding on a contract to build the floor at the Algiers Locks in Louisiana. The Government required a bid bond, and the surety company had informed Hutchinson that it would not issue a bond on Corporation's bid unless an additional $50,000 in cash was absolutely subordinated to the contract. "[C]orporation's funds were pretty well tied up" at that time in other jobs, and the bank with which Corporation normally did its business refused to lend it the additional money. On May 29th, 1947, Foundation's board of directors agreed to advance $50,000 to Corporation in return for

one-third of the profits from the job, plus repayment of the advance.

Shortly thereafter, Hutchinson advised Foundation that the surety company now insisted on having $75,000 subordinated to the contract instead of the previous $50,000 requirement. On July 1, 1947, the earlier agreement was cancelled, and Foundation agreed to advance the larger amount to Corporation in return for one-half of the profits from the contract, plus repayment of the advance. Corporation's bid was accepted, and Foundation advanced the $75,000.

In 1948, Foundation advanced an additional $40,000 to Corporation to pay for certain material required before further work could be done on the project. No additional consideration was received by Foundation for this $40,000, but the sum was ultimately returned.

Before the Algiers Lock floor contract was completed, Corporation bid on the contract for erection of the walls at the same lock, received the award, and unsuccessfully attempted to secure a bond for the contract bid without being required to furnish additional funds. After Corporation's bank once again would not advance the funds, the agreement between Foundation and Corporation covering the floor contract was extended to the wall contract, and the $75,000 previously advanced was left with Corporation.

Before the wall contract was completed, Corporation was invited by T. L. James & Company, Inc. (James) to bid on the contract for the Cheatham Lock project in Tennessee. James and Corporation were awarded the contract and agreed to divide the profits from the project equally. Since Foundation then extended the financial terms of the Algiers

Lock project agreement to cover the Cheatham Lock project, half of Corporation's share of the profits under the Cheatham contract was to go to Foundation. In addition to the $75,000 covered by the extended agreement, Foundation also advanced $25,000 on August 20, 1951, and $50,000 on October 4, 1951 for use on the Cheatham Lock project.

The $75,000 original advance and the $75,000 additional investment in the Cheatham Lock project in 1951 were returned to Foundation about 1953, and its construction project relationship with Corporation was terminated in 1954. Foundation was adequately compensated for its involvement in the construction projects, and no part of the profits it derived from them was diverted to its members.

Sometime in 1947 or 1948, Stevens secured a patent for a therapeutic heating device for Foundation. The costs of developing and manufacturing the heaters were incurred by Partnership and treated as a gift by it to Foundation. Foundation distributed free of charge to hospitals, old folks' homes, and individuals about 100 heaters worth approximately $4,510.25.

About 1952, Foundation began making educational loans to college students. Repayment was waived in the case of most or all of the 32 loans, totaling $4,605, made during Foundation's taxable years 1952 through 1955. For its taxable years 1956 through 1958, Foundation made 36 loans, totaling $7,496, which are extended without question when a student advances a good reason for delay in payment.

Foundation's books indicate receipts, disbursements and student loans as follows:

Fiscal Year Through	Contributions received and other income	Expenses	Contributions, Gifts, Grants, Etc.	Student Loans	Surplus Balance
1947	$105,611.75	$139.87	$4,227.50	730.00	$101,244.38
1948	87,810.98	27.00	1,245.25	1,725.00	187,783.11
1949	35,024.83	19,315.75	235.00	5,001.00	203,257.19
1950	181,471.85	24,715.33	1,825.00	.....	358,188.71
1951	94,967.41	19,237.00	1,000.00	.....	432,919.12
1952	73,782.91	19,230.00	1,250.00	.....	486,222.03
1953	38,317.89	19,295.00	2,090.00	.....	503,154.92
1954	19,741.79	9,630.00	3,931.64	.....	509,335.07
1955	20,680.41	1,450.00	2,015.00	.....	526,550.48
1956	14,331.00	1,392.20	2,150.00	.....	537,339.28
1957	24,278.26	3,571.00	1,600.00	.....	556,446.54
1958	49,014.52	2,050.55	1,725.00	.....	601,685.51
Total	$745,033.60	$120,053.70	$23,294.39	$7,496.00	

Partnership loaned certain sums of money to Foundation from February, 1946, to October, 1953. The total outstanding on the first day of any month during that period ranged from $496,973.71 to $969,211.62, and averaged $783,266.59 for that period. Foundation paid no interest on these loans through 1948, and thereafter until 1954 paid various rates of interest. Since 1954 Foundation has not borrowed funds from Partnership or from any other source and has not paid any interest to Partnership.

At the time of trial herein, Foundation's investments had a total value of $950,000.

On or before August 20, 1953, Foundation's members determined a plan to accumulate $1,000,000 in Foundation, from which they calculated an annual income of $50,000 could be derived. They deemed this income sufficient to meet expenses and still carry out Foundation's charitable purposes.

On information returns for each of its taxable years 1948 through 1954, Foundation answered "No" to the following questions:

> "Have you had any sources of income or engaged in any activities which have not previously been reported to the Bureau? ..... If so, attach detailed statement."

By letter dated August 24, 1954, Commissioner notified Foundation that its tax exempt status was revoked. By letter dated September 8, 1954, the District Director at St. Paul notified Foundation that it was liable for federal corporation income tax returns and enclosed forms for the years 1948 to 1953, inclusive. After audit, various conferences and other negotiations, Commissioner notified Foundation of specific deficiencies by letter of June 14, 1960.

I—Exemption Issue

(a)—Non-Charitable Operation

Under § 101 (6) of the Internal Revenue Code of 1939 and § 501 (c) (3) of the 1954 Code, an organization is entitled to be exempt from taxation if it satisfies the following conditions: (1) it must be organized and operated exclusively for religious, charitable * * * or educational purposes; (2) no part of its net earnings can inure to the benefit of any private shareholder or individual; (3) it cannot engage in substantial political or lobbying activity.

The crucial question here is whether Foundation's participation in the Algiers and Cheatham Lock projects supports the Tax Court's finding that it was not operated "exclusively" for charitable purposes and that such involvement was "to a substantial extent an effort to benefit its founders." In our view, this is largely a fact issue and, being so, the finding of the Tax Court must stand unless it is clearly erroneous or was induced by an erroneous view of the law. See and compare *Samuel Friedland Foundation v. United States*, D. N.J., 144 F. Supp. 74, 85 (1956); *Cleveland Chiropractic College v. C.I.R.*, 8 Cir., 312 F. 2d 203, 204 (1963).

The meaning of the term "exclusively" as used in the statutes is no longer open to debate. In *Better Business Bureau v. United States*, 326 U.S. 279 (1945), the Supreme Court, in giving effect to § 814 (b) (8) of the Social Security Act (in terms substantially the same as § 501 (c) (3) of Int. Rev. Code), made this pronouncement:

> "In this instance, in order to fall within the claimed exemption, an organization must be devoted to educational purposes exclusively. This plainly means that the presence of a single noneducational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes." 326 U.S. at 283.

See also, *Duffy v. Birmingham*, 8 Cir., 190 F. 2d 738 (1951); *American Institute for Economic Research v. United States*, Ct. Cl., 302 F. 2d 934 (1962), cert. denied, 372 U.S. 976 (1963); *Scripture Press Foundation v. United States*, Ct. Cl., 285 F. 2d 800 (1961), cert. denied, 368 U.S. 985 (1962); *Leon A. Beeghly Fund v. Commissioner of Internal Revenue*, 35 T.C. 490, 523 (1960), affirmed 310 F. 2d 756 (6 Cir. 1962).[1] So here, in order for Foundation to occupy exempt status, it must be devoted to *charitable* purposes *exclusively*, and if there is present in its operations a single noncharitable purpose substantial in nature, though it may have other truly and important charitable purposes, it is not entitled to be exempt.

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[1] In **Beeghly**, the Tax Court found that the Fund was not operated "exclusively" for charitable purposes and thus that it was not tax exempt. But, on another ground, the Tax Court held that the Fund had no deficiency in income tax. On appeal by the Commissioner, the Sixth Circuit affirmed the Tax Court without reaching the issue of "charitable operation."

Foundation insists that its participation in the Algiers and Cheatham Lock projects was incidental to its tax exempt purposes, was not in furtherance of substantial nonqualified purposes, and that the benefits derived by its founders from such transactions were of an incidental nature. Additionally, Foundation emphasizes that if benefited from the business ventures to the extent of $178,387.55. From the foregoing, Foundation reasons that it was in fact operated exclusively for charitable purposes within the concept of the teachings of the Supreme Court in *Better Business Bureau v. United States*, supra, 326 U.S. 279.

We have accorded these and other arguments advanced by Foundation due and careful consideration and are not persuaded that the finding of the Tax Court on this issue is clearly erroneous. To the contrary, we are convinced that such finding is supported by substantial evidence and that in reaching its conclusion that Tax Court applied the proper legal standards. In the final analysis, it cannot be denied that the funds of Foundation were used in an appreciable amount and in a manner which, while beneficial to Foundation, also resulted in a substantial benefit to its founders. It was hardly a coincidence that Foundation was contacted by Mr. Hutchinson and asked to give financial support to Corporation's construction ventures. Upon a reasonable assessment of the undisputed facts, a logical inference is that Foundation came to the rescue of Corporation at a time when the latter was unable to procure additional financing from its bank and other sources and when it was hard put for the requisite amount of cash necessary to satisfy the bonding company, and that Foundation made it possible for Corporation to bid on the projects. And, of course, it is of prime significance that the controlling interest in Corpo-

ration was owned by the individuals who constituted Partnership and who also were the creators of Foundation. The amount involved in the construction projects belies the assertion that these business ventures were merely incidental; or that the profit, as channeled through Corporation to Partnership and ultimately realized by Foundation's creators, was of an incidental nature. In our view, the questioned activities and the use made of Foundation funds in connection with such activities closely parallel, in principle, the situation in *Leon A. Beeghly Fund*, supra, 35 T.C. 490, where, as here, the organization forfeited its tax exempt status because of such activities. We are likewise of the view that *Samuel Friedland Foundation v. United States*, supra, 144 F. Supp. 74, upon which Foundation places strong reliance, is readily distinguishable and not controlling herein.

On the noncharitable operation issue we sustain the Tax Court.

(b)—Unreasonable Accumulations

Encompassed within the exemption issue, the Tax Court also found that Foundation had unreasonably accumulated income during its taxable years 1952 through 1958. We affirm this finding.

Under § 3814 of the Internal Revenue Code of 1939[2] and 31, 1950.

§ 504 of the 1954 Code (the successor to § 3814), tax exempt status is denied to any organization described in § 501 (c) (3) of the 1954 Code,

> "if the amounts accumulated out of income during the taxable year or any prior taxable year and not actually paid out by the end of the taxable year—

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[2] § 3814 of the 1939 Code was enacted in 1950. § 333 of Act September 23, 1950, provided in part that this section should apply with respect to taxable years beginning after December

"(1) are unreasonable in amount or duration in order to carry out the charitable, educational, or other purpose or function constituting the basis for exemption * * *."

In the *Friedland* case, supra, 144 F. Supp. at 92, the court, in considering the yardstick to be applied in determining whether accumulations were unreasonable, stated,

"What the true test appears to be is this.—Does the charitable organization have a concrete program for the accumulation of income which will be devoted to a charitable purpose and in the light of existing circumstances is the program a reasonable one?"

While realizing that no formula is devisable for determining reasonableness in all cases, the court pointed to four significant factors to be considered, applied them to the facts, and found that Friedland Foundation had a definite and reasonable program and a charitable object for accumulation. These factors were: (a) Purpose of accumulation and dollar goal—$500,000 for construction of medical research center at Brandeis University; (b) Funds available at starting point to be devoted to accumulation—$50,000; (c) Likelihood of further contributions—$50,000 per year; and (d) Extent of time required to reach dollar goal—6, 7 or 8 years.

In *Erie Endowment v. United States*, 3 Cir., 316 F. 2d 151 (1963), the Third Circuit, confronted with the same problem, affirmed the district court's holding that the accumulations were unreasonable. In so doing, the court took note of the ruling of the Tax Court in this case, see Note 16, 316 F. 2d at 155, stated that the factual situations in the two cases were comparable, see Note 19, 316 F. 2d at 155, 156, and also made the following general pronouncement:

> "'Reasonableness,' that hobgoblin of judicial minds, can only be defined on the basis of all relevant facts. The standard to be applied is whether the taxpayer can justify the total accumulation of income at the end of the taxable year, in terms of both time and amount, on the basis of a rational total program of charitable intent. The plan must be viewed in its entirety. An eight year plan of accumulation to provide a medical research center for a university costing $500,000 may be reasonable; so may a ten-year period of accumulation to build up sufficient funds to pay retirement benefits to employees where that is the sole purpose of the foundation so may accumulation for the purpose of obtaining sufficient funds to construct and maintain a civic building where the charitable organization was formed for that specific purpose." 316 F. 2d at 155.

Mindful of these principles, we are impelled to conclude that the Tax Court here correctly decided that the accumulations were unreasonable within the meaning of the statute. Several salient facts stand out. Foundation did not have a concrete or definite charitable program requiring the accumulation of a large percentage of its income. Under its corporate charter, Foundation possessed broad charitable powers, but the fact remains that it failed to formulate and design a meaningful charitable program, one having a definite functional objective. We recognize that at some time during the years in question—the Tax Court found that it was on or before August 20, 1953—Foundation determined that its dollar goal value would be $1,000,000, and that based upon a 5% return, its annual investment income would be $50,000. We have also considered that in 1951 or 1952 Foundation began making educational loans to students attending colleges. However, these loans and grants were not made

at the result of any formulated or definite plan and such aid was not geared to the amount of Foundation's income. In the absence of a concrete program no reasonable justification appears for the large accumulations for the years in question.[3]

Neither are we impressed with Foundation's argument that the Tax Court improperly considered accumulations prior to the enactment of the unreasonable accumulations statute in 1950. As demonstrated, this Act operated prospectively to deny tax exempt status. However, it is clear from the wording of the statute that accumulations of the taxable year and preceding years are to be *considered* in resolving the question whether the accumulations were unreasonable. See *Erie Endowment v. United States*, supra, 316 F. 2d at 156, fn. 20.

2—Retroactive Revocation Issue

By letter dated May 1, 1947, the Commissioner informed Foundation that it was exempt from federal income tax under the provisions of § 101(6) of the Internal Revenue Code and that "accordingly, you will not be required to file income tax returns unless you change the character of your organization, the purposes for which you were organized, or your method of operation. Any such changes should be reported immediately to the collector of internal revenue for your district in order that their effect upon your exempt status may be determined." As previously stated, the Com-

[3] The Tax Court determined that—"if we adopt the approach of **Friedland** [supra, 144 F. Supp. 74] in determining the amount of 'excess' accumulations"—Foundation's "excess" accumulations, as of its taxable year 1958, totaled—"**per petitioner's books**"—$443,372.34. Using the Tax Court's figures in this regard, Commissioner points out that Foundation accumulated approximately 78% of its income during the years before the court, while spending only 3% for charitable purposes.

missioner revoked this tax exemption ruling by letter to Foundation dated August 24, 1954. Thereafter, the Commissioner applied the revocation ruling retroactively.

The Commissioner is empowered to prescribe the extent to which any ruling made by him shall be applied retroactively. Section 7805(b) of the 1954 Code provides:

> "The Secretary or his delegate may prescribe the extent, if any, to which any ruling or regulations, relating to the internal revenue laws, shall be applied without retroactive effect."

This section is substantially the same as its predecessor—§3791(b) of the 1939 Code. In *Automobile Club v. Commissioner*, 353 U.S. 180, 184 (1957), the Supreme Court stated that it is clear from the language of the foregoing statute and its legislative history that Congress thereby confirmed the authority of the Commissioner to correct any ruling, regulation or treasury decision retroactively, but empowered him, in his discretion, "to limit retroactive application to the extent necessary to avoid inequitable results."

> "The Commissioner's action may not be disturbed unless in the circumstances of this case, the Commissioner abused the discretion vested in him by section 3791(b) of the 1939 code." 353 U.S. at 184.

See and compare, *Birmingham Business College, Inc. v. C.I.R.*, 5 Cir., 276 F. 2d 476 (1960); *Lesavoy Foundation v. Commissioner of Internal Revenue*, 3 Cir., 238 F. 2d 589 (1956); *Cleveland Chiropractic College v. C.I.R.*, supra, 8 Cir., 312 F. 2d 263.[1] Thus, the question for decision here is whether the Commissioner acted arbitrarily in directing that the ruling be applied retroactively.

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[1] The revocation of taxpayer's exempt status in **Cleveland Chiropractic College** was applied retroactively. However, this was not an issue on appeal and is not mentioned in our opinion.

Foundation's efforts to demonstrate that its information reports were adequate and sufficient to apprise the Commissioner of its entry into the business activities which led to denial of its tax exempt status are far from convincing. By way of summary, it appears that on July 1, 1947, shortly after the tax exempt ruling, Foundation became involved with Corporation in the Algiers Lock project, but failed to disclose this fact to the Commissioner in its information return filed for its taxable year which ended March 31, 1948. To the contrary, Foundation answered "No" to the question:

> "9. Have you had any sources of income or engaged in any activities which have not previously been reported to the Bureau?
>
> (Yes or No)
>
> If so, attach detailed statement."

Foundation also failed to disclose its assets and liabilities as required on "Schedule A—Balance Sheets" of the information return. Likewise, Foundation in its returns filed for taxable years ending March 31, 1949, March 31, 1950, and March 31, 1951, disclosed no information of its activities with Corporation, although as previously shown, it became further involved in the lock projects. The first hint of the transaction appeared in Foundation's information return filed for the year ending March 31, 1950, when under heading "10—Other Income," Foundation reported "Algiers Lock Investment $128,410.60." This amount was more than 10% of the total income reported for that year, but Foundation failed to attach an itemized schedule in accordance with the instructions. Again in its 1951 return, Foundation reported under "Other Income—Algiers Lock Investment $24,198.21," and again also failed to attach the required itemized schedule.

Apparently, examination of the 1951 return and discovery of the $24,198.71 item of income caused the Commissioner to begin the investigation which resulted in his revocation of the 1947 ruling.

The foregoing events and the ensuing correspondence between Commissioner and Foundation negate arbitrary action or an abuse of discretion by Commissioner.

Foundation seeks to draw an analogy between this case and *Lesavoy Foundation v. Commissioner*, supra, 238 F. 2d 589, where the Third Circuit reversed the Tax Court, 25 T.C. 924, which had sustained the Commissioner's retroactive revocation of a certificate of exemption from taxation issued to a charitable organization. In our view, *Lesavoy* is readily distinguishable. There, unlike the present situation, the Foundation reported on its information return that it had engaged in "activities which have not previously been reported to the Bureau," revealed that it had purchased a spinning mill company, and attached a balance sheet listing assets, inventory, liabilities, and gross receipts which reflected substantial sales of yarn and cloth.

On this issue we affirm the Tax Court.

3—Personal Holding Company Issue

Sustaining the Commissioner in part, the Tax Court held that Foundation qualified as a personal holding company for its taxable years 1952 through 1954 and 1956 through 1958. We reverse the Tax Court on this issue.

Under the Personal Holding Company statute, § 501 (a) of the 1939 Code and § 542 (a) of the 1954 Code, the term "personal holding company" means any corporation (with certain exceptions not pertinent here) if—(1) at least 80 percent of its gross income for the taxable year is personal

holding company income as defined in another section (502 of 1939 Code, 543 of 1954 Code), and (2) at any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals.[1]

As in the Tax Court, Foundation here concedes that it meets test (2)—i.e., it had the requisite kind of income to be a personal holding company. The crucial question is whether the requirements of test (2) are present—i.e., whether Foundation's "members" are of the general equivalence of stockholders in stock corporations so as to satisfy the stock ownership test.

The provisions of Foundation's corporate charter pertinent to this issue provide that: the corporation does not have authority to issue capital stock; the four incorporators shall be members upon payment of $1 each to the corporation; no part of the corporation's net income shall inure to the benefit of any member; and the corporation has broad powers to amend any provision of the charter. The charter does not provide for distribution of assets upon dissolution.

Although Foundation never issued capital stock or amended its charter, Commissioner contended in the Tax Court that

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[1] During the years in question, Foundation had no more than ten members. The Tax Court reduced the number to five for personal holding company purposes under the "ownership attribution" rules of the Code (§ 503 of the 1939 Code and § 544(a)(2) of the 1954 Code). Although Foundation asserts that these rules could only become applicable **after** an actual merger by it with a profit corporation (if such merger is possible), Foundation does not dispute the finding that the family relationship between its members is sufficient to reduce the owners to five or less under the rules, if such determination is to be made regardless of an actual merger. Since we dispose of the personal holding company issue on another ground, further consideration of this phase of the issue is unnecessary.

because of the reserved power to amend the charter, Foundation's members had the right to share in its property upon dissolution and therefore were equivalent to stockholders in stock corporations. The Tax Court held that for the taxable year 1948 Foundation's memberships did not correspond to stock holdings for personal holding company tax purposes, but on a theory of its own, sustained the Commissioner on this issue as to other taxable years.

In 1951 the Delaware legislature amended its Revised Code of 1935 to permit consolidation of or merger between stock and non-stock corporations. This amendment added a new section to the Delaware Revised Code of 1935, now appearing as § 2-7, Title 8, of Delaware Code Annotated, and reading in pertinent part as follows:

> "257. Any one or more non-stock corporations, whether organized for profit or not organized for profit, organized under the provisions of this chapter, or existing under the laws of this State, may consolidate or merge with one or more stock corporations, whether organized for profit or not organized for profit, organized under the provisions of this chapter, or existing under the laws of this State, into a single corporation which may be any one of the constituent corporation or a new corporation to be formed by means of such consolidation or merger as shall be specified in the agreement provided for in subsection (b) of this section. The new corporation or the surviving constituent corporation may be organized for profit or not organized for profit and may be a stock corporation or a membership corporation.
>
> "* * * In such consolidation or merger the interests of members of a constituent non-stock corporation may be treated in various ways so as to convert such interests into interests of value, other than shares of stock, in the proposed new or resulting stock corporation or into

shares of stock in the proposed new or resulting stock corporation, voting or non-voting, or into creditor interests or any other interests of value equivalent to their membership interests in their non-stock corporation."

Without supporting authority, the Tax Court concluded that "despite the fact that the predecessors of Del. Code Ann. tit. 8, secs. 102 (a) (4), 242 (a), and 281, set forth *supra*,[6] were not amended by this 1951 Act, we conclude that the Delaware Legislature intended to and did change the law to give to members in nonstock corporations the right to share in the current or accumulated profits of those corporations," and that for the taxable years 1952 through 1958 Foundation's membership constitute "stock" within the meaning of the Personal Holding Company statute.

Although we sustained the determination that Foundation was not an exempt organization for *federal* income tax purposes, the present issue posits the question whether under *state law*, the property of a charitable organization can be distributed or paid to its members by way of dividends or ultimately on dissolution. The Commissioner recognizes that we look to the state law in resolving this question, and in his brief, states:

"Taxpayer is a nonstock nonprofit corporation organized under the General Corporation Law of Delaware . . . and its certificate of incorporation makes no provision for the disposition of assets in the event of dissolution. However, on the basis of the relevant state law,

[6] These provisions of Del. Code Ann. tit. 8—dealing in part, respectively, with formation of non-profit, non-stock corporations, with charter amendments, and with distribution of balance upon corporate liquidation—were interpreted by the Tax Court, in light of Delaware decisional law, as forbidding—prior to 1951—distribution of accumulated profits to members of a non-profit, non-stock corporation on liquidation.

> the Tax Court determined that, prior to 1951, members of a Delaware nonstock nonprofit corporation could not share in the assets of the corporation on liquidation. . . . Accordingly, it found that prior to that time taxpayer's memberships were not equivalent to stock for personal holding company purposes because they lacked the necessary beneficial interest in the assets of the corporation."

Specifically, then, we must decide whether the 1951 amendment was intended to cover *charitable* non-stock, non-profit corporations so as to permit Foundation to merge with a profit, stock corporation and to give Foundation's members—as held by the Tax Court—the right to share in the current or accumulated profits of Foundation, even though there was no actual merger. Foundation states that the Tax Court's interpretation of the amendment—now Title 8, Del. Code Ann., § 257—endangers the status of existing charitable corporations under Delaware law, and, in effect, prohibits the formation of new ones. Commissioner, in support of the Tax Court's self-spun theory, argues that for state law purposes, charitable corporation is not endangered in Delaware, for it will remain charitable in nature until merged with a stock company. Opposed to Foundation's contention that the doctrine of *cy pres* would prevent its funds from being diverted to its members, Commissioner further asserts that the doctrine, although applied in Delaware as to charitable trusts, has not yet been applied as to charitable corporations "and would appear to be foreclosed by the 1951 amendment. . . ." Commissioner points to the general liberality of Delaware corporation law, asserts that "the legislature apparently saw fit to allow" such mergers, and on oral argument, revealed that perhaps the Delaware statute "would permit a church to merge with a large profit corporation.".

In our view, the Tax Court's interpretation of § 257 is diametrically opposed to prevailing principles of law dealing with charitable corporations. Generally, on the dissolution of a charitable corporation, the doctrine of *cy pres* is applicable, and a gift to the corporation does not revert to the donor—and, to be sure, cannot be distributed to the members of the charitable corporation. See IX Scott, Trusts § 397.3, at 2797-2798 (2d ed. 1956). Ordinarily, the principles which are applicable to charitable trusts are applicable to charitable corporations—certainly the doctrine of *cy pres* pertains to both, and "it is probably more misleading to say that a charitable corporation is not a trustee than to say that it is. . ." IV Scott, Trusts § 348.1, at 2559, 2553-2554 (2d ed. 1956); *The National Foundation v. First National Bank of Catawba Co.*, 4 Cir., 288 F. 2d 831, 836 (1961); *Miller v. Mercantile-Safe Deposit & Trust Company*, 224 Md. 380, 168 A. 2d 184, 188 (1961); *Trustees of Rutger's College in N. J. v. Richman*, 41 N. J. Super. 259, 125 A. 2d 40, 26 (1956). It has been held that the legislature has no power to destroy or to vary the terms of a valid charitable trust. IV Scott, Trusts § 348, at 2552 (2d ed. 1956). Additionally, the power of amending a corporate charter cannot be exercised to entirely change the nature of a corporation, or to change substantially its objects and purposes. Fletcher, Cyclopedia Corporations, Vol. 7, Ch. 43, § 3718, at 886 (Perm. ed.).

With these general rules in mind, we turn to Delaware law to determine whether its legislature and its courts have adhered to the prevailing principles. We, like the Tax Court and the parties to this action, recognize that the Delaware statutory law here involved has not been construed by the courts of that state insofar as it applies to non stock, non profit corporations. Nevertheless, upon careful scrutiny of

Delaware statutory and decisional law, we are firmly convinced that the Tax Court's interpretation of that law is erroneous.

The Delaware courts have recognized that "generally speaking, the law favors charitable trusts, and they will not be declared void if they can by any possibility, consistent with law, be considered as good." *Union Methodist Episcopal Church v. Equitable Trust Company*, 32 Del. Ch. 197, 893 A. 2d 111, 114 (1951). Construing a testamentary bequest in trust for a charitable purpose, the Court of Chancery of Delaware, in *Delaware Trust Company v. Graham*, 30 Del. Ch. 330, 61 A. 2d 110, 113 (1948), stated that there "seems to be no good reason why judicial cy pres should not be applied in appropriate cases by this court." Other Delaware decisions dealing with charitable trusts have also recognized the validity of the *Cy pres* doctrine, although the courts have not always considered its application appropriate under the facts involved. See, for example, *Union Methodist Episcopal Church v. Equitable Sec. Tr. Co.*, 177 A. 2d 217 (1962); *First National Bank & Trust Company v. First National Bank & Trust Company*, 35 Del. Ch. 449, 121 A. 2d 296 (1956); *Union Methodist Episcopal Church v. Equitable Trust Company, supra*, 83 A. 2d 111. Furthermore, under the doctrine of *cy pres*, the Delaware legislature cannot divert the corpus of a trust to uses other than those specified, nor may it terminate a charitable trust, or change the methods of its administration. "Legislation respecting a charitable trust is valid if in aid of its purpose and not in destruction or impairment of the interests arising under it." *Trustees of New Castle Common v. Gordy*, 93 A. 2d 507, 515 (1952).

It is also interesting to note that in *Buckley v. Independence Foundation*, 181 A. 2d 78, 83 (1962), the Delaware Court

of Chancery, while finding it unnecessary to determine the validity of plaintiff's assertion "that an incorporated charitable foundation is governed by the same rules of law as are charitable trusts, did state:

> "Determination of the issues presented here is dependent upon the extent of the powers conferred upon Independence by its certificate of incorporation. If the power to make the contested grant is either expressly or by necessary implication given by its charter then it matters not whether trust law or corporate law is applicable. Conversely, if the power is not so given the grant is ultra vires and ineffective, at least in the absence of unanimous membership approval, and, perhaps, even then." 181 A. 2d 83.

Moreover, we find that Delaware, like other American courts, also favors charitable corporations, and in cases involving such institutions, is "not confined to the same orthodox concepts which once were applicable to every situation * * *" *Danby v. Osteopathic Hospital Association of Delaware*, Del. Sup., 104 A.2d 903, 907 (1954). Other cases, such as *Society for Propagation of Faith v. Josuisk*, Del. Ch., 180 A.2d 617 (1962), and *Equitable Security Trust Co. v. Home for Aged Women*, 35 Del. Ch. 553, 123 A.2d 117 (1956), further emphasize that the Tax Court's interpretation of § 257 would frustrate Delaware's policy toward charitable institutions.

Since statutes are presumed to have some effect, § 257 must be interpreted as allowing many types of non-profit, non-stock corporations to merge with profit corporations. But a non-profit corporation is not necessarily charitable in nature, *Reade v. Tidewater Coal Exchange*, 13 Del. Ch. 195, 116 A. 898 (1922), and allowing a merger between a profit corporation and a certain type of non-profit corporation is a far cry

from allowing merger between a charitable corporation and a profit corporation, and allowing assets pledged to charitable purposes to be diverted to private gain. In our view, if such a drastic change was intended, the Delaware legislature would have spoken more clearly; it would have specifically referred to charitable corporations by name—as it does in various other sections of the Code whereby certain charitable associations are granted various rights and exemptions. See, Del. Code Ann., tit. 8, §§ 313, 361(a)(4), 501; tit. 30, § 1902.

To sustain the Tax Court on the personal holding company issue, we would, among other determinations, be obliged to hold that: (1) under § 257, Foundation *could* merge with a profit corporation, and that therefore Foundation's memberships were converted to interests of value; (2) such interests were the equivalent of stock; and (3) the Delaware legislature, by implication in § 257, intended to prevent the courts from applying the doctrine of *cy pres* to charitable corporations. Such determinations, in our view, would not coincide with how the Delaware courts would interpret § 257 if they were called upon to do so. We reverse the Tax Court on this issue.

b. Additions to Tax Issue

The Tax Court assessed penalties under § 291(a) of the 1939 Code for failure of Foundation to file income tax returns for its taxable years 1948 through 1954 and personal holding company tax returns for its taxable years 1952 through 1954.

In summary, § 291(a) provides that in case of any failure to file a tax return within the time prescribed by law, unless it is shown that the failure is due to reasonable cause and not due to willful neglect, there shall be added to the tax a certain percentum thereof not to exceed 25% in the aggregate.

The Tax Court considered all of the facts and circumstances bearing upon this issue, carefully considered Foundation's contentions, applied what it regarded to be the applicable rule, and found that Foundation did not have reasonable cause for failure to file the returns for the years stated.

The question whether the failure to file returns was due to reasonable cause and not due to willful neglect is "one of fact in the first instance for the * * * [Tax Court's] determination." *Commissioner v. Lane-Wells Company*, 321 U.S. 219, 225 (1944). In *Coates v. Commissioner of Internal Revenue*, 8 Cir., 234 F. 2d 459, 462 (1956), Judge Sanborn, speaking for the court, stated:

> "We agree with the statement of the Tax Court that whether or not reasonable cause exists for failure to file the required declaration is a question of fact to be decided upon the peculiar circumstances of each case."

To the same effect are *Sami v. United States*, 5 Cir., 277 F. 2d 153 (1960); *Southeastern Finance Company v. Commissioner of Int. Rev.*, 5 Cir., 1955 F.2d 205 (1946). Cf. also *Heman v. C.I.R.*, 8 Cir., 283 F.2d 227 (1960).

Foundation seeks to demonstrate that reasonable cause existed for its failure to file the income tax returns. Its principal argument is grounded on the 1947 ruling of the Commissioner that it was exempt and not required to file such returns. Of course, the exemption ruling ostensibly justified the failure to file such returns. However, since we have determined that the Commissioner was justified in retroactively revoking the exemption ruling for failure to furnish material information, such reason ceases to exist. See *Birmingham Business College, Inc. v. C.I.R.*, supra, 276 F.2d at 482.

We have carefully considered all arguments advanced by Foundation and are satisfied that the Tax Court's determina-

tion that Foundation is subject to additions for failure to file the income tax returns for the years 1948 through 1954 should be affirmed. Inasmuch as we have determined that Foundation was not a holding company and was therefore not required to file personal-holding company tax returns, there is no basis for those additions, and the Tax Court's decision in that regard is reversed.

5—Worthless Securities Issue

Foundation claimed capital losses in its taxable year 1949 totaling $9,849.40, alleging that the stock it held in Denver & Rio Grande Railway and in St. Louis & San Francisco Railway became worthless in that year. The Tax Court sustained the Commissioner's disallowance of the claimed capital losses on the ground that Foundation "failed to sustain its burden of proving the stock became worthless during the period before the Court."

In contending that it incurred such losses in 1949, or alternatively in 1948 or 1950, Foundation relies *entirely* upon the opinion-testimony of its president, Stevens. The Tax Court obviously was not impressed with Stevens' testimony, determined that the testimony was of little value in fixing either the fact or time of worthlessness, and—contrarily—pointed to other evidence suggesting the stock probably was not worthless in 1949. On this record, we cannot hold that the Tax Court's determination—a finding of fact—was clearly erroneous. See *Commissioner v. Duberstein*, 363 U.S. 278, 291 (1960); *Boeckm v. Commissioner*, 326 U.S. 287, 292-293 (1945); *Midland-Ford Tractor Company v. C.I.R.*, 8 Cir., 277 F.2d 111, 115 (1960), cert. denied, 364 U.S. 881 (1960); *Cohen v. Commissioner*, 2 Cir., 148 F.2d 336, 337 (1945).

6—Long-Term Capital Gain Issue

After completion of the Cheatham Lock project, Corporation sold the steel sheet piling and division equipment used on the project. Foundation contends that, if it is not tax exempt, its share of the profit realized from the sale of the piling and the equipment is a long-term capital gain under § 1231 of the Internal Revenue Code of 1954. The Tax Court affirmed the Commissioner's determination that the profit constituted ordinary income and not capital gain.

To qualify as a long-term capital gain under § 1231, the profit must have been realized from the sale of "property used in the trade or business." Such property, according to § 1231(b), must (1) be used in the trade or business; (2) be subject to the allowance for depreciation; and (3) be held for more than six months.

The Tax Court sustained Commissioner's determination as to the steel pilings on the ground that Foundation failed to satisfy its burden of proving that it or Corporation had held the pilings for more than six months. Based largely upon the testimony of Stevens, the Tax Court found that the pilings had been transferred to the Corps of Engineers during the construction project, causing an interruption in the holding period so as to disqualify the property from capital gain treatment under the "6-month" requirement of § 1231(b). Foundation contends that the Tax Court's finding is erroneous in that Stevens' testimony was somewhat inconsistent and that "a fair interpretation of Mr. Stevens' testimony is there was no *real* or *actual* interruption of the holding period."

While there can be no doubt that Stevens' testimony was not entirely consistent, it furnished a substantial basis for the Tax Court's finding. On review, primary emphasis must

be given to the evidence which supports the inferences drawn by the Tax Court, *Commissioner v. Scottish American Company*, 323 U.S. 119, 123-124 (1944); *Card v. Commissioner*, 8 Cir., 216 F.2d 93, 96-97 (1954), and a choice between two permissible views of the weight of the evidence is not clearly erroneous. *United States v. Yellow Cab Co.*, 338 U.S. 338, 342 (1949). Thus, in view of the lack of evidence to the contrary, we cannot overturn the finding that Foundation failed to prove that it held the pilings for more than six months, and thus that it could not treat its share of the profit from their sale as a capital gain.

In sustaining the Commissioner's denial of capital gain treatment for the *equipment*, the Tax Court merely stated that Foundation had not proved the equipment was depreciable as required by § 1231(b). No one disputed Stevens' testimony that the equipment was used on the Cheatham project and that it, but "not the supplies," had depreciated. The Commissioner never suggested to the Tax Court that Foundation had not shown the depreciable nature of this equipment, and the point was not at issue below.

To be sure, the Tax Court is the judge of the credibility of witnesses who appear before it, and of the weight of evidence produced. But, under the circumstances of this case, we believe that Foundation "might fairly have assumed that the respondent was not questioning or controverting" its assertions or its evidence as to the depreciable nature of the equipment. *Royal Highlanders v. Commissioner of Internal Revenue*, 8 Cir., 138 F.2d 240, 245 (1943). While the Tax Court may not have been required to find for Foundation upon the evidence it produced, the court should have afforded Foundation an opportunity to verify its position since the deprecia-

tion issue" had not really been raised. On the equipment portion of the issue we reverse and remand to allow either party an opportunity to present evidence as to whether the equipment was depreciable, and thus to determine whether Foundation's share of the profit from its sale was a long-term capital gain under § 1231.

Conclusion

In accordance with our determinations as set forth in the opinion, we affirm in part, reverse in part, and reverse and remand in part.

A true copy.

Attest:

Clerk, U. S. Court of Appeals, Eighth Circuit.

JUDGMENT

UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

No. 17,332. September Term, 1963.

Stevens Bros. Foundation, Inc., Petitioner, vs. Commissioner of Internal Revenue.	On Petition to Review Decision of The Tax Court of the United States.

This cause came on to be heard on the petition to review the decision of The Tax Court of the United States entered on December 14th, 1962, determining that there are deficiencies in the corporate income and personal holding company taxes and penalties of petitioner for the years 1948 through 1954, and was argued by counsel.

On Consideration Whereof, It is now here Ordered and Adjudged by this Court as follows:

1. That on the Non-Charitable Operation Issue, the decision of the Tax Court be, and is hereby, affirmed.
2. That the Findings of The Tax Court that the Foundation had unreasonably accumulated income during the taxable years 1952 through 1958 be, and it is hereby, affirmed.
3. That on the Retroactive Revocation issue, the ruling of The Tax Court is hereby, affirmed.

4. That on the Personal Holding Company Issue, the ruling of The Tax Court is hereby reversed.
5. That on the Additions to Tax issue, the Ruling of the Tax Court that Foundation is subject to additions for failure to file income tax returns for t[illegible] years 1948 through 1954 is hereby affirmed, but inasmuch as this Court has determined that Foundation was not a Holding Company, and therefore not required to file personal holding company tax returns, there is no basis for those additions, and the decision of The Tax Court in that regard is hereby, reversed.
6. That on the Worthless Securities Issue, the determination of The Tax Court be, and is hereby, affirmed.
7. That on the Long-Term Capital Gain Issue as to the sheet-steel pilings, the ruling of The Tax Court, is hereby affirmed.
8. That on the Equipment portion of the Long-Term Capital Gain issue, the ruling of The Tax Court is reversed and remanded with directions to allow either party an opportunity to present evidence as to whether the equipment was depreciable, and thus to determine whether Foundation's share of the profit from its sale was a long-term capital gain under § 1231.

And it is hereby Ordered and Adjudged by this Court that this cause be, and it is hereby, remanded to the said Tax Court of the United States for proceedings not inconsistent with the Opinion of this Court this day filed herein.

November 15th, 1963.

Order entered in accordance with Opinion:

ROBERT C. TUCKER
Clerk, U. S. Court of Appeals,
Eighth Circuit

Statutes

SEC. 501. EXEMPTION FROM TAX ON CORPORATIONS, CERTAIN TRUSTS, ETC.

(a) Exemption From Taxation. — An organization described in subsection (c) or (d) or section 401 (a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502, 503, or 504.

26 USC § 501(a) p. 4368

(b) Tax on Unrelated Business Income. — An organization exempt from taxation under subsection (a) shall be subject to tax to the extent provided in part II of this subchapter (relating to tax on unrelated income), but, notwithstanding part II, shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

26 USC § 501(b) p. 4368

(c) List of Exempt Organizations. — The following organizations are referred to in subsection (a):

• • • • • •

(3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements) any political campaign on behalf of any candidate for public office.

26 USC § 501(c) p. 4368

• • •

SEC. 503. REQUIREMENTS FOR EXEMPTION.

(a) Denial of Exemption to Organizations Engaged in Prohibited Transactions. —

(1) General rule. —

* * *

(2) Taxable years affected. — An organization described in section 501 (c) (3) or section 401 (a) shall be denied exemption from taxation under section 501 (a) by reason of paragraph (1) only for taxable years after the taxable year during which it is notified by the Secretary or his delegate that it has engaged in a prohibited transaction, unless such organization entered into such prohibited transaction with the purpose of diverting corpus or income of the organization from its exempt purposes, and such transaction involved a substantial part of the corpus or income of such organization.

26 USC § 503(a)(2) p. 4370

* * *

(c) Prohibited Transactions — For purposes of this section, the term "prohibited transaction" means any transaction in which an organization subject to the provisions of this section —

(1) lends any part of its income or corpus, without the receipt of adequate security and a reasonable rate of interest, to;

(2) pays any compensation, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered, to;

(3) makes any part of its services available on a preferential basis to;

(4) makes any substantial purchase of securities or any other property, for more than adequate consideration in money or money's worth, from;

(5) sells any substantial part of its securities or other property, for less than an adequate consideration in money or money's worth, to; or

(6) engages in any other transaction which results in a substantial diversion of its income or corpus to;

the creator of such organization (if a trust); a person who has made a substantial contribution to such organization; a member of the family (as defined in section 267(c)(4) of an individual who is the creator of such trust or who has made a substantial contribution to such organization, or a corporation controlled by such creator or person through the ownership, directly or indirectly, of 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of the corporation.

26 USC § 503(c) p. 4371

SEC. 504. DENIAL OF EXEMPTION.

(a) General Rule. — In the case of any organization described in section 501 (c) (3) to which section 503 is applicable, exemption under section 501 shall be denied for the taxable year if the amounts accumulated out of income during the taxable year or any prior taxable year and not actually paid out by the end of the taxable year—

(1) are unreasonable in amount or duration in order to carry out the charitable educational, or other purpose or function constituting the basis for exemption under section 501 (a) of an organization described in section 501 (c) (3); or

(2) are used to a substantial degree for purposes or functions other than those constituting the basis for exemption under section 501 (a) of an organization described in section 501 (c) (3); or

(3) are invested in such a manner as to jeopardize the carrying out of the charitable, educational, or other purpose or function constituting the basis for exemption under section 501 (a) of an organization described in section 501 (c) (3).

Paragraph (1) shall not apply to income attributable to property of a decedent dying before January 1, 1951, which is transferred under his will to a trust created by such will. In the case of a trust created by the will of a decedent dying on or after January 1, 1951, if income is required to be accumulated pursuant to the mandatory terms of the will creating the trust, paragraph (1) shall apply only to income accumulated during a taxable year of the trust beginning more than 21 years after the date of death of the last life in being designated in the trust instrument.

26 USC § 504(a) p. 4372

SEC. 511. IMPOSITION OF TAX ON UNRELATED BUSINESS INCOME OF CHARITABLE, ETC., ORGANIZATIONS.

(a) Charitable, etc., Organizations Taxable at Corporation Rates.—

(1) Imposition of Tax. — There is hereby imposed for each taxable year on the unrelated business taxable income (as defined in section 512) of every organization described in paragraph (2) a normal tax and a surtax computed as provided in section 11. In making such computation for purposes of this section, the term "taxable income" as used in

section 11 shall be read as "unrelated business taxable income".

(A) Organizations described in section 501 (c) (2), (3), (5), (6), and (17), and section 401 (a). — The taxes imposed by paragraph (1) shall apply in the case of any organization (other than a church, convention or association of churches, or a trust described in subsection (b)) which is exempt, except as provided in this part, from taxation under this subtitle by reason of section 501 (c). Such taxes shall also apply in the case of a corporation described in section 501 (c) (2) if the income is payable to an organization which itself is subject to the taxes imposed by paragraph (1) or to a church or to a convention or association of churches.

* * *

SEC. 512. UNRELATED BUSINESS TAXABLE INCOME.

(a) Definition — The term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the exceptions, additions, and limitations provided in subsection (b). In the case of the organization described in section 511 which is a foreign organization, the unrelated business taxable income shall be its unrelated business taxable income derived from sources within the United States determined under subchapter N (sec. 861 and following, relating to tax based on income from sources within or without the United States.)

* * *

SEC. 513. UNRELATED TRADE OR BUSINESS.

(a) General Rule. — The term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of an organization described in section 511 (a) (2) (B), to the exercise or performance of any purpose or function described in section 501 (c) (3)), except that such term does not include any trade or business—

(1) in which substantially all the work in carrying on such trade or business is performed for the organization without compensation; or

(2) which is carried on, in the case of an organization described in section 501 (c) (3) or in the case of a college or university described in section 511 (a) (2) (B), by the organization primarily for the convenience of its members, students, patients, officers, or employees; or

(3) which is the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions.

* * *

SEC. 6213. RESTRICTIONS APPLICABLE TO DEFICIENCIES; PETITION TO TAX COURT.

(a) Time for Filing Petition and Restriction on Assessment. — Within 90 days, or 150 days if the notice is addressed to a person outside the States of the Union and the District of Columbia, after the notice of deficiency authorized

in section 6212 is mailed (not counting Saturday, Sunday, or a legal holiday in the District of Columbia as the last day), the taxpayer may file a petition with the Tax Court for a redetermination of the deficiency. Except as otherwise provided in section 6861 no assessment of a deficiency in respect of any tax imposed by subtitle A or B and no levy or proceeding in court for its collection shall be made, begun, or prosecuted until such notice has been mailed to the taxpayer, nor until the expiration of such 90-day or 150-day period, as the case may be, nor, if a petition has been filed with the Tax Court, until the decision of the Tax Court has become final. Notwithstanding the provisions of section 7421(a), the making of such assessment or the beginning of such proceeding or levy during the time such prohibition is in force may be enjoined by a proceeding in the proper court.

SEC. 7442. JURISDICTION.

The Tax Court and its divisions shall have such jurisdiction as is conferred on them by this title, by chapters 1, 2, 3, and 4 of the Internal Revenue Code of 1939, by title II and title III of the Revenue Act of 1926 (44 Stat. 10-87), or by laws enacted subsequent to February 26, 1926.

SEC. 7482. COURTS OF REVIEW.

(a) Jurisdiction. — The United States Courts of Appeals shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provided in section 1254 of Title 28 of the United States Code, in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury; and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari,

in the manner provided in section 1254 of Title 28 of the United States Code.

SEC. 7483. PETITION FOR REVIEW.

The decision of the Tax Court may be reviewed by a United States Court of Appeals as provided in section 7482 if a petition for such review is filed by either the Secretary (or his delegate) or the taxpayer within 3 months after the decision is rendered. If, however, a petition for such review is so filed by one party to the proceeding, a petition for review of the decision of the Tax Court may be filed by any other party to the proceeding within 4 months after such decision is rendered.

SEC. 7805. RULES AND REGULATIONS.

(b) Retroactivity of Regulations or Rulings. — The Secretary or his delegate may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect. Source: Sec. 3791(b), 1939 Code, substantially unchanged.

26 USC § 7805(b) p. 4881

• • •

Internal Revenue Code of 1939

SEC. 53. TIME AND PLACE FOR FILING RETURNS.

(a) Time for Filing. —

(1) General Rule. — Returns made on the basis of the calendar year shall be made on or before the fifteenth day of March following the close of the calendar year, except that in the case of the return of the fiduciary of an estate or trust, the return shall be made on or before the fifteenth day of April following the close of the calendar year. Returns made on the basis of a fiscal year shall be made on or before the fifteenth day of the third month following the close of the fiscal year, except that in the case of the return of the fiduciary of an esta or trust, the return shall be made on or before the fifteenth day of the fourth month following the close of the fiscal year.

(2) Extension of Time. — The Commissioner may grant a reasonable extension of time for filing returns, under such rules and regulations as he shall prescribe with the approval of the Secretary. Except in the case of taxpayers who are abroad, no such extension shall be for more than six months.

26 USC § 53(a) (1939)

* * *

SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS.

Except as provided in supplement U, the following organizations shall be exempt from taxation under this chapter —

* * * *

(6) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for

the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation. For loss of exemption under certain circumstances see sections 3813 and 3814.

26 USC §101(6) (1939)

* * *

SEC. 291. FAILURE TO FILE RETURN.

(a) In case of any failure to make and file return required by this chapter, within the time prescribed by law or prescribed by the Commissioner in pursuance of law, unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the tax: 5 per centum if the failure is for not more than thirty days with an additional 5 per centum for each additional thirty days or fraction thereof during which such failure continues, not exceeding 25 per centum in the aggregate. The amount so added to any tax shall be collected at the same time and in the same manner and as a part of the tax unless the tax has been paid before the discovery of the neglect, in which case the amount so added shall be collected in the same manner as the tax. The amount added to the tax under this section shall be in lieu of the 25 per centum addition to the tax provided in section 3612 (d) (1).

26 USC § 291(a) (1939)

SEC. 3791. RULES AND REGULATIONS.

(b) Retroactivity of regulations or rulings. — The Secretary, or the Commissioner with the approval of the Secretary, may prescribe the extent, if any, to which any ruling, regula-

tion, or Treasury Decision, relating to the internal revenue laws, shall be applied without retroactive effect.

SEC. 3813. REQUIREMENTS FOR EXEMPTION OF CERTAIN ORGANIZATIONS UNDER SECTION 101 (6) AND FOR DEDUCTIBILITY OF CONTRIBUTIONS MADE TO SUCH ORGANIZATIONS.

* * *

(b) Prohibited Transactions — For the purposes of this section, the term "prohibited transaction" means any transaction in which an organization subject to the provisions of this section —

(1) lends any part of its income or corpus, without the receipt of adequate security and a reasonable rate of interest, to;

(2) pays any compensation, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered, to;

(3) makes any part of its services available on a preferential basis to;

(4) makes any substantial purchase of securities or any other property, for more than adequate consideration in money or money's worth, from;

(5) sells any substantial part of its securities or other property, for less than an adequate consideration in money or money's worth, to; or

(6) engages in any other transaction which results in a substantial diversion of its income or corpus to;

the creator of such organization (if a trust); a person who has made a substantial contribution to such organization; a member of the family (as defined in section 24 (b) (2) (D)) of an individual who is the creator of such trust or who has

made a substantial contribution to such organization; or a corporation controlled by such a creator or person through the ownership, directly or indirectly, of 50 per centum or more of the total combined voting power of all classes of stock entitled to vote or 50 per centum or more of the total value of shares of all classes of stock of the corporation.

(c) Denial of Exemption to Organizations Engaged in Prohibited Transactions. —

(1) General Rule. — No organization subject to the provisions of this section which has engaged in a prohibited transaction after July 1, 1950 shall be exempt from taxation under section 101 (6).

(2) Taxable Years Affected. — An organization shall be denied exemption from taxation under section 101 (6) by reason of paragraph (1) only for taxable years subsequent to the taxable year during which it is notified by the Secretary that it has engaged in a prohibited transaction, unless such organization entered into such prohibited transaction with the purpose of diverting corpus or income of the organization from its exempt purposes, and such transaction involved a substantial part of the corpus or income of such organization.

26 USC § 3813 (b) and (c) (1939)

SEC. 3814. DENIAL OF EXEMPTION UNDER SECTION 101 (6) IN THE CASE OF CERTAIN ORGANIZATIONS ACCUMULATING INCOME.

In the case of any organization described in section 101 (6) to which section 3813 is applicable, if the amounts accumulated out of income during the taxable year or any prior tax-

able year and not actually paid out by the end of the taxable year —

(1) are unreasonable in amount or duration in order to carry out the charitable, educational, or other purpose or function constituting the basis for such organization's exemption under section 101 (6); or

(2) are used to a substantial degree for purposes or functions other than those constituting the basis for such organization's exemption under section 101 (6); or

(3) are invested in such a manner as to jeopardize the carrying out of the charitable, educational, or other purpose or function constituting the basis for such organization's exemption under section 101 (6),

exemption under section 101 (6) shall be denied for the taxable year.

26 USC § 3814 (1939) (applicable to years beginning after December 31, 1950)

Other Statutes

REVENUE ACT OF 1950

§ 302. EXEMPTION OF CERTAIN ORGANIZATIONS FOR PAST YEARS.

(a) Trade or business not unrelated. — For any taxable year beginning prior to January 1, 1951, no organization shall be denied exemption under paragraph (1), (6), or (7) of section 101 of the Internal Revenue Code on the grounds that it is carrying on a trade or business for profit if the income from such trade or business would not be taxable as unrelated business income under the provisions of Supple-

ment U of the Internal Revenue Code, as amended by this Act, or if such trade or business is the rental by such organization of its real property (including personal property leased with the real property).

(b) Period of limitations. — In the case of an organization which would otherwise be exempt under section 101 of the Internal Revenue Code were it not carrying on a trade or business for profit, the filing of the information return required by section 54 (f) of the Internal Revenue Code (relating to returns by tax-exempt organizations) for any taxable year beginning prior to January 1, 1951, shall be deemed to be the filing of a return for the purposes of section 275 of the Internal Revenue Code (relating to period of limitation upon assessment and collection). In the case of such an organization which was, by the provisions of section 54 (f) of the Internal Revenue Code, specifically not required to file such information return, for the purposes of the preceding sentence a return shall be deemed to have been filed at the time when such return should have been filed had it been so required. The provisions of this subsection shall not apply to a taxable year of such an organization with respect to which, prior to September 20, 1950, (1) any amount of tax was assessed or paid, or (2) a notice of deficiency under section 272 of the Internal Revenue Code was sent to the taxpayer.

Internal Revenue Regulations

§ 1.501(c)(3) - (c) (1)

(c) Operational test. (1) Primary activities. An organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes

specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

§ 1.501-(c)(3)-1(e)(1)

(e) Organizations carrying on trade or business—(1) In general. An organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513. In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes. An organization which is organized and operated for the primary purpose of carrying on an unrelated trade or business is not exempt under section 501(c)(3) even though it has certain religious purposes, its property is held in common, and its profits do not inure to the benefit of individual members of the organization. See, however, section 501(d) and § 1.501(d)-1, relating to religious and apostolic organizations.

Revenue Rulings

54-164 (1954-1 Cum. Bull. 88, 91)

* * *

SEC. 6. REVIEW AND CONFERENCES.

.01 The National Office shall conduct such review of de-

termination letters issued by District Directors' offices (including tentative determination letters) as is considered necessary to assure conformity with the interpretations and policies of the Revenue Service. "It is the general policy of the Internal Revenue Service to limit the revocation of a ruling with respect to an organization previously held to qualify under section 101 to a prospective application only, if the organization has acted in good faith in reliance upon the ruling issued to it and a retroactive revocation of such ruling would be to its detriment."

* * *

Other Rulings

GCM 23688, 1943 Cum. Bull. 283

SEC. 19.101(9)-1: SOCIAL CLUBS. 1943-13-11471

Internal Revenue Code and Prior Revenue Acts

The M Association, functioning as a federation of automobile clubs and managing agency of several local automobile clubs, is not a "club" within the meaning of section 101(9) of the Internal Revenue Code and corresponding provisions of prior Revenue Acts, nor is it organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes within the meaning of that section.

G. C. M. 3555 (C. B. VII-4, 117 (1928) and G. C. M. 2867 (C. B. VII-1, 115 (1928) revoked. Recommended that O. D. 643 (C. B. 3, 241 (1920)) be revoked and that I. T. 2106 (C. B. III-2, 228 (1924)) be modified.

* * *

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735-108—64

In the Supreme Court of the United States

OCTOBER TERM, 1963

No. 830

STEVENS BROS. FOUNDATION, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHT CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (Pet. A1–A71) is reported at 39 T.C. 93. The opinion of the court of appeals (Pet. A73–A101) is reported at 324 F. 2d 633.

JURISDICTION

The judgment of the court of appeals was entered on November 15, 1963 (Pet. A102–A103). The petition for a writ of certiorari was filed on February 13, 1964. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether the taxpayer was properly denied exempt status for the period 1948 through 1955 because

it was not operated exclusively for charitable purposes, as required by Sections 101(6) of the 1939 Code and 501(c)(3) of the 1954 Code.

2. Whether the taxpayer was properly denied exempt status for the period 1952 through 1958 pursuant to Sections 3814 of the 1939 Code and 504 of the 1954 Code because its accumulation of earnings was unreasonable in amount and duration.

3. Whether the Commissioner abused his discretion in retroactively revoking his 1947 ruling that the taxpayer was exempt from income tax as a charitable organization.

4. Whether the taxpayer had reasonable cause for failure to file income tax returns for the years 1948 through 1954 so as not to be liable for additions to tax under Section 291(a) of the 1939 Code.

STATUTES INVOLVED

Sections 101(6), 291(a), 3791(b), and 3814 of the Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.) and Sections 501 (a) and (c), 504(a) and 7805(b) of the Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.) are set forth in the appendix to the petition (Pet. A104–A116).

STATEMENT

Taxpayer was incorporated under the laws of Delaware on December 31, 1942, by Edward Fenton Stevens, his wife, and two of his brothers, and maintains its principal office in St. Paul, Minnesota. On May 1, 1947, the Commissioner of Internal Revenue issued a ruling that taxpayer was exempt from federal income taxes as a charitable corporation under Section 101(6) of the 1939 Code, subject to redetermination if it

changed its character, purpose or method of operation (Pet. A74–A75).

The four persons who incorporated the taxpayer were also members of a partnership known as Stevens Bros. Contractors. During the years here involved, the partnership owned two-thirds of the stock, and Stevens was president, of a construction company known as Stevens Bros. & Miller-Hutchinson Company, Inc. (Pet. A75). During the period 1947 through 1954, the taxpayer entered into a series of construction joint ventures with the corporation (Pet. A12–A15, A75–A77). Both courts below concluded that a major purpose of taxpayer's involvement in the construction projects was to benefit its founders through their interest in and indirect control over the corporation (Pet. A15, A81, A81).

Sometime in 1947 or 1948, Stevens secured a patent for a therapeutic heating device on behalf of the taxpayer. The costs of developing and manufacturing the heaters were incurred by the partnership and treated as a gift by it to the taxpayer. About 100 heaters, worth approximately $4,510.25, were distributed free of charge by the taxpayer to individuals, hospitals, and old folks' homes (Pet. A77).

Taxpayer began making educational loans to college students about 1952. Repayment was waived in the case of most or all of the 32 loans, totalling $4,605, made during the taxable years 1953 through 1955. For its taxable years 1956 through 1958, taxpayer made 36 loans, totalling $7,496, which are extended without question when a student advances a good reason for delay in payment (Pet. A77).

Taxpayer's books indicate receipts, disbursements and student loans as follows (Pet. A77–A78):

Fiscal year through—	Contributions received and other income	Expenses	Contributions, gifts, grants, etc.	Student loans	Surplus balance
1947	$106,611.75	$139.87	$4,227.50		$101,244.38
1948	87,810.98	27.00	1,245.25		187,783.11
1949	35,024.83	12,315.75	235.00		203,267.19
1950	181,471.85	24,713.33	1,825.00		358,188.71
1951	94,967.41	19,237.00	1,000.00		432,919.12
1952	73,782.91	19,230.00	250.00		486,222.03
1953	38,317.89	19,295.00	2,000.00		503,154.92
1954	19,741.79	9,630.00	3,991.64		509,335.07
1955	20,680.41	1,450.00	2,915.00		526,550.48
1956	14,331.00	1,392.20	2,150.00	$779.00	537,339.28
1957	24,278.26	3,571.00	1,600.00	1,725.00	556,446.54
1958	49,014.52	2,050.55	1,725.00	5,001.00	601,685.51
Total	745,033.60	120,053.70	23,294.39	[1] 7,496.00	

[1] The listing of the student loans as having been made during the years 1947–1949 in the court of appeals' opinion (Pet. A78) is a typographical error (see Pet. A18).

On or before August 20, 1953, taxpayer's members planned to have the taxpayer accumulate $1,000,000 from which they calculated taxpayer could derive an annual income of $50,000. They expected this to be sufficient to meet the taxpayer's expenses and have a significant sum available for charitable purposes (Pet. A78).

By letter dated August 24, 1954, the Commissioner notified the taxpayer that its tax-exemption ruling was revoked because it had not been operated exclusively for charitable purposes and because it had spent only a nominal amount of its substantial income for purposes upon which its tax-exempt status was based (Pet. A20).

ARGUMENT

The decision below is correct. There is no conflict of decisions or any other basis for further review by this Court.

1. To qualify for income tax exemption under Section 101(6) of the 1939 Code (Pet. A112) or its successor, Section 501(c)(3) of the 1954 Code (Pet. A104), a corporation must be "organized and operated exclusively for * * * charitable * * * purposes". The term "exclusively" has been interpreted by this Court in a similar context to mean that a single nonexempt purpose, if substantial in nature, will defeat the claim to exemption. *Better Business Bureau* v. *United States*, 326 U.S. 279, 283.

Both courts below found that taxpayer's involvement in joint construction ventures with a corporation controlled by its founders was "to a substantial extent an effort to benefit its founders" (Pet. A15, A31, A79, A81). The Tax Court concluded that taxpayer "was not operated exclusively for tax-exempt purposes" (Pet. A31), and the court of appeals agreed, stating that the record belied any assertion that such activities were "of an incidental nature" (Pet. A82). These conclusions are supported by the undisputed facts—the manner in which taxpayer's founders benefited from its advancement of funds to a corporation which they controlled (Pet. A31), the circumstances, particularly the timing, of the advances (Pet. A30–A31), and the size of the amounts devoted by taxpayer to the construction ventures in relation to the insignificant amount of funds disbursed for charitable purposes (Pet. A18). In effect, the taxpayer was being used to finance the construction ventures.

2. Exemption from income tax is denied to any organization whose accumulations out of income are "unreasonable in amount or duration". Section 3814 (1) of the 1939 Code (Pet. A115–A116); Section 504 (a)(1) of the 1954 Code (Pet. A106–A107). The purpose of these provisions is to force exempt organizations to distribute substantial portions of current income for exempt purposes. H. Rep. No. 2319, 81st Cong., 2d Sess., p. 40. Taxpayer in the case at bar accumulated $601,685.51 during the period 1947–1958, while distributing only insignificant amounts for charitable purposes (Pet. A18). On or before August 20, 1953, those in control of taxpayer had determined to accumulate $1,000,000, which—if producing income of $50,000 per year—would permit taxpayer to meet all operating expenses and have a significant sum available for charitable purposes (Pet. A19). Nothing appears in the record, however, with respect to any "functional objective" of this accumulation in terms of specific charitable uses (Pet. A33–A34). Both courts below agreed that, on these facts, taxpayer's accumulations were unreasonable in amount and duration (Pet. A34, A82–A83). The standard applied by the courts below—the existence of a concrete or definite charitable program (Pet. A38, A84)—is in line with *Erie Endowment* v. *United States*, 316 F. 2d 151 (C.A. 3d), which is the only other appellate case in which the issue has been considered. More importantly, it is the minimum interpretation of the "unreasonable accumulations" provisions consistent with the legislative purpose behind their enactment.

3. The Commissioner of Internal Revenue has discretionary power to determine the extent, if any, to which a revenue ruling shall not be retroactive. Section 7805(b) of the 1954 Code (Pet. A111); *Automobile Club* v. *Commissioner*, 353 U.S. 180. In this case, the Commissioner revoked on August 24, 1954, a ruling which earlier (May 1, 1947) had advised taxpayer that it was exempt from income tax and that income tax returns need not be filed "* * * unless you change the character of your organization, the purposes for which you were organized or your method of operation" (Pet. A10). Both courts below found that the retroactive application of the latter ruling was justified because of changed conditions which taxpayer had not brought to the attention of the Commissioner of Internal Revenue (Pet. A27, A87–A88). That conclusion is in accord with *Birmingham Business College, Inc.* v. *Commissioner*, 276 F. 2d 476 (C.A. 5th); and *Kenner* v. *Commissioner*, 318 F. 2d 632 (C.A. 7th). Apart from the question of whether the Commissioner of Internal Revenue ever may be estopped from the retroactive revocation of a ruling his action in this case was clearly warranted.

4. Similarly, taxpayer has no basis for complaint with respect to the additions to tax imposed under Section 291(a) of the 1939 Code (Pet. A113), for failure to file income tax returns for the years 1948–1954. The only "reasonable cause" asserted by taxpayer for failure to file returns was the advice of an attorney that the May 1, 1947, ruling excused it from filing returns (Pet. A63). In view of the fact that the revenue ruling was expressly limited to taxpayer's

purposes and operations at the time of issuance, taxpayer had no reason to believe that its altered purposes and activities were similarly exempt. Moreover, the question of whether failure to file returns was due to reasonable cause and not to willful neglect is "one of fact in the first instance for the * * * [Tax Court's] determination". *Commissioner* v. *Lane-Wells Co.*, 321 U.S. 219, 225.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

ARCHIBALD COX,
Solicitor General.
LOUIS F. OBERDORFER,
Assistant Attorney General.
GILBERT E. ANDREWS,
RALPH A. MUOIO,
Attorneys.

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IN THE

Supreme Court of the United States

No. 830

Civil

STEVENS BROS. FOUNDATION, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR RE-HEARING OF ORDER DENYING PETITION FOR WRIT OF CERTIORARI

JOHN M. SULLIVAN
Attorney for Petitioner
W2200 First National Bank
Building
St. Paul, Minnesota 55101

Of Counsel:
BRIGGS AND MORGAN
W2200 First National Bank
Building
St. Paul, Minnesota 55101

CApital 2-2701 — Review Publishing Co., 141 E. 5th St., St. Paul 1, Minn. — CApital 2-2701

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COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR RE-HEARING OF ORDER DENYING PETITION FOR WRIT OF CERTIORARI

Petitioner prays for re-hearing of the order entered April 6, 1964, denying the petition for writ of certiorari in the above-entitled case.

As grounds for this petition, petitioner respectfully represents:

1. Petition for writ of certiorari herein was filed on or about February 13, 1964.

2. Respondent's brief in opposition to said petition was filed with the Court on or about March 20, 1964.

3. Petitioner diligently undertook to cause to be prepared a reply to said brief in opposition.

4. Petitioner had not had an opportunity to file said reply at the time this Court entered its order denying the petition as aforesaid.

5. The reply to said brief in opposition contains matters which properly should be considered by this Court before its determination on whether this Court should issue its writ herein.

6. Copy of the reply brief is attached hereto. Petitioner respectfully requests its examination by the Court and prays that based thereon and upon all the files and proceedings herein the Court issue its writ to the Court of Appeals for the Eighth Circuit.

Respectfully submitted,

JOHN M. SULLIVAN
Attorney for Petitioner

CERTIFICATE

JOHN M. SULLIVAN hereby certifies that the foregoing petition is presented in good faith and not for delay* and further certifies that the petition is presented upon substantial grounds available to petitioner although not previously presented, the substantial grounds being the decision by the Court herein upon the petition for a writ without the Court's consideration of petitioner's reply to the respondent's brief in opposition to the petition.

JOHN M. SULLIVAN

* Delay is not an element in this case inasmuch as before the appeal to the Court of Appeals for the Eighth Circuit, the Foundation paid the entire amount of tax, interest and penalties determined to be owing by the Tax Court, and the effect of the decision by the Circuit Court was to require repayment by the Commissioner of taxes, penalties and interest in an amount in excess of $200,000.00.

IN THE

Supreme Court of the United States

October Term 1963

No. 830

STEVENS BROS. FOUNDATION, INC.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

REPLY BRIEF FOR PETITIONER

JOHN M. SULLIVAN
Attorney for Petitioner
W2200 First National Bank Building
St. Paul, Minnesota 55101

Of Counsel:
BRIGGS AND MORGAN
W2200 First National Bank Building
St. Paul, Minnesota 55101

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Argument

(1) The respondent opposes granting the petition for writ of certiorari and asserts as reasons (a) that maintenance of tax exemption requires an organization be operated "exclusively" for "charitable" purposes, (b) that existence of non-exempt purpose, if substantial in nature, will defeat exemption, (c) that the petitioner aided its founders and consequently it did not thereby operate exclusively for charitable purposes but operated principally, and not, incidentally, for non-exempt purposes (p. 5 et seq.). Such assertions merely repeat the errors committed below.

Among the issues to be considered by this Court is the question whether a participation in an activity negates one purpose and consequently creates another, or whether the participation furthers the principal purpose, as is contended here. This is a basic distinction. By ignoring it respondent merely repeats, without analysis or explanation, the violence done the statutes and the law by equating activity and purpose. The argument set out in the Petition (pp. 10-11) has not been answered, merely ignored.

The respondent enumerates many of the consequences of engaging in the activity described and would have the Court conclude from such enumeration that the activity therefore evidenced an abandonment of one purpose and the adoption of another; that the Foundation's investment in joint construction ventures substituted a new purpose to benefit Foundation's creators for the abandonment of the old "charitable purposes" prescribed in its charter.

The statement (p. 5) "In effect, the taxpayer [Foundation] was being used to finance the construction ventures" is exactly the obverse of the fact. The construction venture was used to fund the Foundation to the extent of $178,387.55 (Pet. A 81).

The allegation that investment in a construction company was "to a substantial extent an effort to benefit its founders" (p. 5) was and is a proposition which no candid presentation of the facts will sanction. It is based upon an assumption (as to which there is no evidence) of benefit in fact, actual or potential, and an inference irreconcilable with all of the evidence of self-serving which is incompatible with the proved charitable purpose and charitable motive.

To sustain the position the respondent must obliterate the distinction between activity and purpose as developed in

Trinidad v. Sagrada Orden de Predicadores, 263 U.S. 578 (1924); and *Samuel Friedland Foundation v. U. S.*, 144 F. Supp. 74 (D.C.N.J. 1956). The respondent consistently perceives purpose in activity. His perception is analogous to his stripping the overalls from a weekend gardener and thereafter forever insisting that it is a dirt farmer in th chauffeur-driven Cadillac on the way to the corporation executive office. This Court is asked to correct such faulty vision.

(2) The respondent's position with respect to the issue of accumulation of income under section 3814 (1) of the 1939 Code (Pet. A-115 - A-116) and section 504 (a) (1) of the 1954 Code (Pet. A-106 - A-107) has undergone an apparent metamorphosis. The implication of the respondent's brief (p. 6) is that the petitioner's goal to accumulate one million dollars to yield sufficient income to carry its current expenses and to leave remaining a substantial sum for charitable purposes is valid, but he contends that such an aim does not have any functional objective, implying presumably that the words of the Foundation's charter which provide that it shall "engage in charitable, educational and public welfare activities of any and all kinds" and "wholly for charity" are not functional objectives. Whether by this distinction he means "charity for the benefit of the Hottentots" is functional, and engagement "in charitable, educational and public welfare activities of any and all kinds" is not, such distinction is a narrow and unwarranted construction of the statutory provisions. The basic exemption statute, section 501 (a) and (c) (3) (Pet. A-104); and the provision, section 504 (Pet. A-106), against accumulations are concerned with "purposes" and not "functional objectives". This Court should review and put aside the arbitrary and capricious constriction of the statute.

Respondent broadly asserts that forcing distributions of current income is explicit in the involved legislative history dealing with that provision. The provision itself plainly states that only unreasonable accumulations are prohibited. Reasonable accumulations are therefore proper. The point here raised is that the determination by the Commissioner, without any standards of any kind, that *this* accumulation for *these* purposes does not suit his whim is arbitrary, capricious and unreasonable.

(3) The respondent contends that retroactive revocation of exemption was justified by Foundation's changed condition which had not been brought to the attention of the Commissioner. This begs the essential question. Pertinent parts of sections 503 (Pet. A-105) and 504 (Pet. A-106) as well as section 502,[1] and corresponding provisions of the 1939 Code (sections 3813, Pet. A-114, 3814, Pet. A-115, and 101[2]) deny exemption under conditions carefully proscribed both as to cause and time when to take effect, particularly under sections 503(a)(2), (d)[3] and 504(a) and 3813(c) and (d)[4]. Such provisions reflect the same principle enunciated in *Automobile Club v. Commissioner*, 353 U.S. 180 (1957), and *Lesavoy Foundation v. Commissioner*, 238 F. 2d 589 (3d Cir. 1956), i.e., withdrawal of exemption without notice is arbitrary and an abuse of discretion. This Court should again confine the Commissioner's discretion to prevent such abuse of authority.

(4) The respondent notes (p. 7) that the petitioner cannot complain about substantial penalties imposed for failure

[1] App. A-1
[2] App. A-1
[3] App. A-2
[4] App. A-3

to file income tax returns since the only reasonable cause was the advice of an attorney that the exemption letter excused the Foundation from filing the returns. The assertion is erroneous and misleading. *The* reasonable cause was and is the proposition that, as a matter of law, the returns were not required to be filed. In addition (Pet. 17-18) the Tax Court applied and the Circuit Court affirmed a construction of the "reasonable-cause" principle which varies from the construction implied by every court except the Tax Court. The proposition that "reasonable cause" is one of fact for the Tax Court posits the application by the Tax Court of the pertinent law.

Respondent would further justify the penalties on the grounds that the petitioner's alleged changed conditions effected a loss of exemption as a consequence of which the petitioner should have known what returns were going to be due. This sort of rationalization evidences the very arbitrary and capricious nature of the Commissioner's position, and fails to note that so long as the exemption letter was outstanding, no returns were due, that petitioner has engaged in a long struggle of, now, ten years, duration to establish that it is an exempt organization, and that the Commissioner moved in, audited and asserted the deficiencies and penalties, here in dispute, even while the petitioner was engaged in efforts to have the exemption issue reconsidered administratively. A review of the entire record will demonstrate the arbitrary and capricious disregard of the existence of, at the very least, the reasonable cause for failure to file returns provided under section 291 (a) of the 1939 Code (Pet. A-113).

(5) Two additional matters should be noted:

(a) The two-page "statement" prejudicially distorts a complicated set of facts and selects therefrom only those

which justify the errors committed by the Tax and Circuit Courts.

(b) Conventionally, the petition and brief in opposition thereto are not the vehicles for a representation of the merits of the cause. Respondent has compressed to three pages of "Argument" his version of two lengthy opinions. Adequate presentation of the merits should be permitted to petitioner by a granting of the writ.

Conclusion

Based upon the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

JOHN M. SULLIVAN

Attorney for Petitioner

APPENDIX

Statutes

1954 INTERNAL REVENUE CODE

Sec. 502. Feeder Organizations

An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under section 501 on the ground that all of its profits are payable to one or more organizations exempt under section 501 from taxation. For purposes of this section, the term "trade or business" shall not include the rental by an organization of its real property (including personal property leased with the real property).

Sec. 503. Requirements for Exemption

* * * * *

(d) FUTURE STATUS OF ORGANIZATIONS DENIED EXEMPTION.—Any organization described in section 501(c)(3) or section 401(a) which is denied exemption under section 501(a) by reason of subsection (a) of this section, with respect to any taxable year following the taxable year in which notice of denial of exemption was received, may, under regulations prescribed by the Secretary or his delegate, file claim for exemption, and if the Secretary or his delegate, pursuant to such regulations, is satisfied that such organization will not knowingly again engage in a prohibited transaction, such organization shall be exempt with respect to taxable years after the year in which such claim is filed.

1939 INTERNAL REVENUE CODE

Sec. 101. Exemptions from Tax on Corporations

* * * * *

An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under any paragraph of this section on the ground that all of its profits are payable to one or more organizations exempt under this section from taxation. For the purposes of this paragraph the term "trade or business" shall not include the rental by an organization of its real property (including personal property leased with the real property).

Sec. 3813. Requirements for Exemption of Certain Organizations under Section 101 (6) and for Deductibility of Contributions made to such Organizations.

* * * * *

(c) DENIAL OF EXEMPTION TO ORGANIZATIONS ENGAGED IN PROHIBITED TRANSACTIONS.—

(1) GENERAL RULE.—No organization subject to the provisions of this section which has engaged in a prohibited transaction after July 1, 1950 shall be exempt from taxation under section 101 (6).

(2) TAXABLE YEARS AFFECTED.—An organization shall be denied exemption from taxation under section 101 (6) by reason of paragraph (1) only for taxable years subsequent to the taxable year during which it is notified by the Secretary that it has engaged in a prohibited transaction, unless such organization entered into such prohibited transaction with the purpose of diverting corpus or income of the organization from its exempt purposes, and such transaction involved a substantial part of the corpus or income of such organization.

(d) FUTURE STATUS OF ORGANIZATION DENIED EXEMPTION.—Any organization denied exemption under section 101 (6) by reason of the provisions of subsection (c), with respect to any taxable year following the taxable year in which notice of denial of exemption was received, may, under regulations prescribed by the Secretary, file claim for exemption, and if the Secretary, pursuant to such regulations, is satisfied that such organization will not knowingly again engage in a prohibited transaction, such organization shall be exempt with respect to taxable years subsequent to the year in which such claim is filed.

* * * * * *